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ECONOMIC IMPACT OF SPENDING REDUCTIONS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

JANUARY 2, 1985

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ECONOMIC IMPACT OF SPENDING REDUCTIONS

WEDNESDAY, JANUARY 2, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 1:31 p.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Dole (chairman) presiding.

Present: Senators Dole, Packwood, Danforth, Wallop, Moynihan, Baucus, and Pryor.

[The press release announcing the hearing and the prepared statement of Senator Dole follows:]

[Press Release from the U.S. Senate, Committee on Finance, SD-219 Dirksen Senate Office Building, December 21, 1984]

FINANCE COMMITTEE ANNOUNCES HEARING ON THE ECONOMIC IMPACT OF SPENDING REDUCTIONS

Senator Bob Dole (R., Kansas), Chairman, and Senator Bob Packwood, Chairman-Elect, of the Senate Finance Committee announced today that the Committee will hold a hearing on January 2, 1985, on the economic impact of spending cuts that reduce the Federal deficit. The hearing will begin at 1:30 p.m. in room SD-215.

Senators Dole and Packwood expressed the hope that the January 2 hearing would set the stage for prompt consideration in the 99th Congress of significant reductions in Federal spending. The Senators indicated that a major goal of the hearing is to explore the immediate and long-term economic benefits from spending reduction, emphasizing how accepting the temporary burden of spending restraint can produce a more productive economy for the nation as a whole.

Legislative Reorganization Act.—Senator Dole stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument".

Witnesses scheduled to testify should comply with the following rules:

(1) All witnesses must submit written statements of their testimony.

(2) Written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be delivered not later than noon on December 31, 1984.

(3) All witnesses must include with their written statements a summary of the principal points included in the statement.

(4) Oral presentations should be limited to a short discussion of principal points included in the one-page summary. Witnesses must not read their written statements. The entire prepared statement will be included in the record of the hearing.

(5) Not more than 1 minute will be allowed for the oral summary.

DOLE SAYS SPENDING CUTS "FIRST AND FOREMOST" IN DEFICIT FIGHT

WASHINGTON—Majority Leader-elect Bob Dole (R-Kansas) said today that cutting the nation's deficit is the top priority of the 99th Congress, which convenes Thursday, January 3.

"The health of our economy is the key to everything we try to achieve, both as individuals and as a nation," Dole said in his final hearing as Chairman of the Committee on Finance. Congress, he emphasized, has a mandate "for attacking spending first and foremost as a means of reducing the deficit."

The complete text of Dole's opening statement at today's hearing:

"I am very glad that we have the opportunity this afternoon to begin tackling the main challenge facing the 99th Congress: How to deal with the budget deficit. While the new Congress will not convene until tomorrow, this hearing is clearly aimed at setting the stage for a major assault on Federal spending in 1985. As far as this Senator is concerned, we cannot begin that effort too soon—and I congratulate Senator Bob Packwood (R-Oregon), who is taking over as Chairman of this Committee, for his work in setting up this hearing.

It is no overstatement to say that cutting the deficit is the top priority of the new Congress. The health of our economy is the key to everything we try to achieve, both as individuals and as a nation. Without a strong economy, we cannot afford to aid the weak and hungry here in America, as well as around the world. Without a strong economy, we lessen the reputation of the free world as the vanguard of human progress. Without a strong economy, we lack the resources to strengthen our defenses and the credibility we need to negotiate with the Soviet Union on our own terms. In a very real sense, the deficit problem is linked to every one of our endeavors: From arms reduction to famine relief.

Let there be no doubt that reducing the deficit is the key to a healthy economy, and that cutting spending is the right way to reduce the deficit. Over the past four years, we have made tremendous strides in the fields of taxation, regulation and monetary policy that have strengthened the economy in important ways.

The tax burden has been restrained and we are in the process of improving the way it is distributed. Regulatory relief has been offered, and the paperwork burden restrained. Inflation has been brought down to manageable levels and we still hope to see it eradicated. But Federal spending and the resulting deficits have yet to be reined in.

Deficits in the $200 billion range drain resources from the private sector, cause uncertainty that boosts interest rates and, consequently, undermine our trading position by keeping the dollar high. That means that, until deficits are reduced, our economic recovery has a kind of instability built into it—an instability that must and will be removed. The general welfare of the nation—which the Constitution instructs us to protect—demands that we act promptly.

Let me just point out that, while we have been cutting programs and implementing tax reforms over the past few years, one program has continued to grow faster than anything else.

That is the interest on the public debt, which jumped 22 percent in fiscal year 1982, 9.5 percent in fiscal year 1983 and 16 percent in fiscal year 1984.

And, the public debt is projected to keep growing at a comparable pace. That means that, unless we rein in deficits and their associated interest costs, interest on the debt can grow large enough to eat up all of the tax relief we have tried to provide, and make a mockery of all of our efforts to cut spending.

It is hard to argue for restraining the growth of food stamps, or Medicare, or of defense if the interest costs keep growing out of control. There are just no painless solutions around here, and it's time to bite the bullet.

Blaming Federal Reserve Board Chairman Paul Volcker is not the answer—it's merely an evasion.

We could debate for the rest of the year—in fact, we have been debating it for several years—the relative merits of spending cuts, tax increases and economic growth as means to reduce the deficit.

But two things ought to be clear at the outset and should guide our choices.

First, strong growth will not be realized unless we have spending cuts that reduce the government's absorption of resources, coupled with a stable and responsible monetary policy. Second, considering tax changes at this time would be highly controversial—particularly with the president—and might impede progress on the deficit.

Besides, most tax changes that raise revenue could not have a favorable effect unless they are linked to spending cuts of a greater magnitude.

All of this translates into a mandate for attacking spending first and foremost as a means of reducing the deficit. Once we have done that, and satisfied the financial markets that we are serious and will stick to our program, we can see where we stand and consider further options. But, today we must focus on the immediate challenge, and I welcome our very distinguished witnesses to join us in our efforts, Senator Dole concluded.

STATEMENT BY SENATOR MAX BAUCUS, SENATE FINANCE COMMITTEE—JANUARY 2, 1985

INTRODUCTION

Thank you, Mr. Chairman.

Two nights ago, the clock in Times Square counted down the final seconds of 1984 and brought in the new year.

And tomorrow, the clocks in Washington will count down the final moments of the 98th Congress and bring in the 99th.

But there's another clock ticking: the deficit clock.

It shows that the Federal budget deficit is increasing by $22 million an hour.

It doesn't stop for holidays, or for Congressional recesses. It keeps ticking inexorably on.

THE DEFICIT PROBLEM

At his rate, our total debt will increase by more than $200 billion this year, and exceed $3 trillion by 1990.

What does this mean?

Such huge and persistent deficits: Drive up interest rates; prevent our farmers and businessmen from competing overseas; put our economy precariously in the hands of foreign investors; and mortgage our children's future, by forcing them to pay for our mistakes.

A CALL FOR ACTION

We need to act and we need to act now.

We must take steps that show that Congress is firmly committed to reducing the deficit.

I believe that there is only one way to accomplish this: A one-year, across-the-board freeze, on all Federal programs: Domestic programs; entitlements; and defense.

No exceptions, no sacred cows.

WHY A FREEZE

A freeze is not perfect. Every member of this Committee, and every member of the Senate, would prefer to cut some programs more and others less.

But that's why a freeze will work. By freezing every program, it will break the political gridlock that has prevented us from reducing the deficit until now.

Democrats give up a little on entitlements. Republicans give up a little on defense.

The result is shared sacrifice and a $150 billion reduction in the deficit over three years.

THIS YEAR'S FREEZE

Last year, Senators Grassley, Kassebaum, Biden and I pushed for such a freeze.

I intend to do the same this year.

I hope that others will support us, so that we can enact the freeze quickly.

That will send a new signal to Wall Street and the financial community that this year Congress is actually going to cut the deficit.

CONCLUSION

Mr. Chairman, I look forward to hearing from today's witnesses. I hope that will encourage Congress to act rapidly and across the board.

Thank you.

The CHAIRMAN. We've been waiting for Dr. Feldstein. I assume he will be here.

I want to thank, first of all, Bob Packwood who tomorrow will assume the chairmanship of this committee. Congratulations, Happy New Year, and a lot of luck with the tax program. [Laughter.]

The CHAIRMAN. We have four very outstanding members of our panel. And I would like to include in the record a statement.

Do you want to make a statement, Bob?

Senator PACKWOOD. Yes.

The CHAIRMAN. Why don't we take turns here and I will come back and make a short statement and we will start.

Senator PACKWOOD. Well, I hope when the witnesses are testifying that they realize this is not a hearing on the fast tax or the flat tax or the fair tax or the fun tax or the vat tax or any other kind of tax. What we are trying to do is to gather information as to what the effects might be on interest rates and on employment if we adopt spending cuts of the magnitude that the administration is talking about. More specifically, it is proposing spending cuts of about $42 billion next year, $85 billion the year after that, and $110 billion in 1988.

So premise your testimony on the assumption that Congress adopts those cuts. Do not focus on whether we will adopt them, nor on whether the cuts should be more in military spending and less some place else, unless you think that the mix of the cuts might have some effect on interest rates and employment.

Of course, being from Oregon, I've got a very deep concern about this. While Oregon's economy is diversifying, timber is still our biggest employer. Housing is timber. Housing is down, timber is down, and when timber is down, Oregon is down.

If with these spending cuts we can get a reduction in interest rates and can look at an increase in housing, we can look at a boom in Oregon, which I have a very deep interest in.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I first congratulate Senator Packwood who will be leading us in the Congress ahead. He knows what is required on this side. And I know that he will continue to keep this committee as open as you did during your tenure. We going to miss you, but we are not going to miss you far. [Laughter.]

Senator MOYNIHAN. I hope our panelists might speak to a subject that is of interest to all of us here, which is the increasing role of debt service in the budget. We are approaching a deficit now in the range of $200 billion, of which three-quarters is interest payments. And, increasingly, we find ourselves in a situation where we are literally borrowing money to pay interest.

The overall debt of more than $1.5 trillion now, if it were paid off over 30 years, would require some $52 trillion. It appears to me that the question of who owes this debt and who will get the payment is likely to involve the largest transfer of wealth from labor to capital that I think has ever been brought about in Congress and in the Federal Government. And perhaps some of our panelists would speak to the question of interest.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Chairman, thank you very much. I, too, want to congratulate both the new leader and the new chairman and express my pleasure at the fringe benefits that have flowed down. [Laughter.]

Mr. Chairman, I think that the American people are always ready and willing to rise to meet a crisis. I think the question that

is before us is do we really have a crisis on our hands. What difference does it make if we have deficits of $200 billion or more? The economy is now doing very well. I think people are reasonably pleased right now. Witness the effect of the results in the election. And, therefore, do deficits really matter very much? Does it matter when the national debt goes from $1 trillion to $2 trillion to $3 trillion or is this just a hypothetical concern?

And if we are going to take some action in reducing the size of the Federal deficit, how much action should we take? How much action do we have to take? Is it worthwhile to do the same thing that we did in 1984 or 1982 and more or less chip away at the size of the deficits? Is a little bit of action satisfactory? Does it make any difference if we reduce the deficit from $200 billion to $150 billion? Or are we in a situation now in which if we are going to do any good at all we may as well address the large questions before us rather than the relatively modest approaches that we have tried in the past.

I think that, obviously, this is the key issue before the Congress in the immediate future, as it has been in the past. And I'm delighted that we have such a prestigious panel before us.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Mr. Leader, Chairman Packwood, Chairman Danforth and other illustrious members of the committee, I first want to thank the Majority Leader/Temporary Chairman of the committee for all the great work that he has done here. I can remember a couple of years ago when in darker days it was very difficult to put together a bipartisan group here in the Congress and in the committee to encourage the White House to get moving more strenuously on these deficits. And it's you, Mr. Chairman, who has put that together on both sides of the aisle on this committee to try to light a fire under the White House and under the Congress and under the country generally to get the budget deficit brought more firmly under control. It's not anything facetious at all, though I would say, Mr. Chairman, in that respect you fall in the position of some great previous chairmen of this committee.

There have been some very illustrious chairmen of the Senate Finance Committee in this committee's history. Senator Daniel Webster, one of the earliest chairmen of this committee, along with Henry Clay. Senator Calhoun was also a chairman of this committee. We have all been graced with the chairmanship of Russell Long for many years in this committee. And it is my hope that his chairmanship returns at some appropriate time.

But in the interim, I think you have met the great tradition of previous chairmen and I think all of us are very proud to serve under you.

Turning to the subject at hand, Mr. Chairman, I'm going to ask the panelists to address themselves to a budget freeze. Senator Grassley unfortunately is not here today and Senator Kassebaum and Senator Biden and myself have pushed for an across the board freeze on Federal spending for 1 year. No sacred cows, you know, nobody is off limit. It includes defense, includes COLA's, includes everything.

It's our belief that something along this line is necessary in order to get some action immediately, right away.

It's our worry that if we go along the usual process of trying to find some areas to cut and some areas not to cut because interest groups and constituencies are so strong in this legislative process that as a consequence not much happens. And I would hope that the panelists do address whether in their judgment a freeze, total freeze, on Federal spending for a year in order to get our act together, to get our house in order, makes sense to them or does not make sense to them.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Thank you, Mr. CHAIRMAN. And like my colleague, Senator Baucus, and others, I would also like to congratulate you, sir, and also to our new Chairman, Senator Packwood. I do look forward to serving with both of you in those new capacities and new roles.

Also reiterating one point made by Senator Baucus. Relative to the freeze, I, too, have been a cosponsor and someone who is very interested and someone who has supported that freeze since May of 1983. I'm planning to support it again if we have the opportunity. And I think that opportunity will avail itself in the coming weeks or months ahead.

But in addition to your comments on a freeze, I would also like to pose to the panel at the proper time for an answer the question of a form of legislation—in fact, I introduced a bill last year in the last session of the Congress—relative to not only a freeze, but also a trust fund created for the sole purpose and the sole purpose only of dealing with the deficit. A deficit reduction fund, I think, under the bill that I introduced was something that is a possibility of legislation and its time has come. Some say it will not work. I would love to hear an answer or response by one or all the members of the panel relative to that concept, especially if they are discernible, identifiable new revenues to be raised.

Right now, we don't like to talk about new revenues, but I would be willing to gamble just about anything that before we wind down, Mr. Chairman, this year's conclusion of this Finance Committee that we will be talking about new revenues. Maybe not enacting new revenues, but at least talking about them. And I would like a response to that area and to those concepts.

Mr. Chairman, thank you for calling this meeting. And once again I look forward to working with you.

The CHAIRMAN. Thank you very much. I would just say very briefly that we are very pleased to have this outstanding panel.

It's my hope that we have already demonstrated—there are three on each side the political aisle here. We have all indicated what we consider to be the No. 1 priority in this country, and that's cutting the deficit. I have to share the view expressed by Senator Moynihan that the fastest growing program in America is not agriculture, defense, Medicare. It's interest on the debt. It jumped to 22 percent in fiscal year 1982, 9½ percent in fiscal year 1983 and 16 percent in fiscal year 1984. It's going to be in this year's budget at about $150 billion just in interest on the debt. Compare that to Jack Kennedy's last budget for the entire Government of about $99.9 billion. It gives you some idea.

And I don't think there are any easy answers. I'm very happy that we took action on 1982 and 1984 at least to stem the hemorrhage because without that action, the deficit would not be $200 billion. It would be closer to $260 billion, $270 billion.

And there may be some magic formula. Maybe we can just blame Paul Volcker, ignore spending and cut taxes. That might work. Some will say it has already worked. But many of us are concerned. I think it's bipartisan.

But I'm afraid if we don't address the deficit, the increased interest costs are going to eat up the tax cuts and eat up all the work we did on restraining spending in this committee and other committees. And it's pretty hard to ask people to make further sacrifices in Medicare, Medicaid, agriculture, food stamps, whatever, unless we are willing to swallow the very bitter medicine and do it very soon.

So I think this hearing and the attendance and the willingness of the panelists to be here indicate that we are serious about it.

And I would ask that my statement be made a part of the record.

Dr. Schultze, you will be first.

Dr. SCHULTZE. You just looked at my hair.

The CHAIRMAN. I looked at Greenspan. [Laughter.]

STATEMENT OF DR. CHARLES SCHULTZE, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. SCHULTZE. Mr. Speaker-elect and Mr. Chairman-elect, and other members of the committee, thanks for inviting me.

You have asked me to talk about the economic consequences of spending cuts. I want to do so in my own way, which is, first, to talk about the consequences of not reducing the deficit—we should ask ourselves what happens if we don't reduce it.

Second, while spending reductions are essential in cutting the budget deficit, spending cuts alone, and especially spending cuts which ignore Social Security and virtually ignore defense, will not be sufficient to bring the deficit down well below $100 billion by 1988, which is a minimum target on the way to balance by 1990.

Let me briefly summarize my first point—the economic effects of the deficit—and then spend a little bit more time on the second part.

What are the impacts of large deficits? In the first place, the impact of large deficits not likely, to be principally in terms of inflation or unemployment. I don't think the large deficits, even if unattended, in the next 2, 3, or 4 years, are going to lead to an outburst of inflation. I don't think they are going to lead to a recession. Now that latter is a little less certain, but I don't think they will, if handled correctly.

We are not facing a crisis. I wish we were. The damage from the budget deficits is not immediate or direct or obvious. Rather, it's long term and indirect and subtle. But just because arsenic doesn't work in a hurry, it doesn't mean it isn't a terribly damaging poison.

Let me start by pointing out that the way the economy behaves under the influence of such huge deficits depends upon the Federal Reserve. I'm convinced the Federal Reserve has been and is still

dedicated to its primary goal of preventing an excessively rapid expansion fed by huge budget deficits from generating new inflationary pressure.

The Fed has been willing and will continue to be willing to do whatever is necessary by way of restrictive monetary policy and high interest rates to squeeze enough other activity out of the economy to make room for Federal borrowing of 5 percent of GNP in a noninflationary manner.

But the Fed also has a second objective. The Federal Reserve does not want, unlike 1981, 1982, to put this economy through the wringer of a recession to get inflation down further. So the Federal Reserve is very sensitive of not going too far with its restrictive monetary policy. When it appears it is making a mistake with too much restraint, which was probably the case this summer, the Federal Reserve has shown its willingness to back off somewhat as it has been doing for several months now in order that the initial restraint is not carried too far and does not lead to a recession.

We are, in other words, running a car with one foot on the brake and one foot on the accelerator. The Fed has to push a little bit more, a little bit less at various times so we get fluctuating interest rates. But, fundamentally, I am convinced that for the foreseeable future with a little bit of luck and some care, the consequences of the deficit are not likely to be a serious recession, or an outbreak of inflation.

In this process, however, of adjusting to a huge Federal budget deficit within the constraint of noninflationary growths, the Federal Reserve has to squeeze something else out of the economy. The Federal Government is borrowing 5 percent of GNP. Something has got to give.

To date, the main area that has given—as the Fed has attempted to squeeze out enough to make room for the Federal deficit—has been the international sector of the U.S. economy. Large deficits, a responsible noninflationary policy by the Fed, high interest rates, and an over-valued dollar have led, as you all know, to substantial restraints on our exports and to a flood of imports. The U.S. merchandise trade balance, which was $25 billion in the red in 1980, will be something like $110 to $120 billion in the red this year, and more next year.

Dollar for the dollar, the mirror image of this excess of imports over exports is an inflow of foreign savings into this country, supplementing our domestic savings. So initially we have made an adjustment to the large deficit by borrowing from abroad. Roughly speaking, about 60 percent of the deficit is now being directly and indirectly financed by foreign borrowing.

But that, in turn, even though it is perhaps a less painful form of adjustment than some of the others, is very costly. The United States is in the process of getting rid of its foreign assets and accumulating foreign debt. We and our children will be paying the debt service, not to ourselves, but to foreigners, as a result of this initial impact of the budget deficit. We will be reducing the growth in our future living standards because, of course, we are now adding about $100 billion a year to the foreign debt we have to pay debt service on.

Next point. Ultimately—now nobody knows when and probably anybody who tells you when you should immediately start by not believing them—but ultimately, foreigners are not going to continue to pour their savings and capital into the United States and continue to buy U.S. securities at the rate they have been doing.

As the foreign inflow of savings shrinks, as it ultimately will—my own judgment is later than sooner—then that deficit has got to be financed out of domestic savings. So far we've been supplementing domestic savings with an inflow of foreign capital, but eventually, we are going to have to adjust by squeezing something else out so we can accommodate the Federal borrowing within our domestic savings.

And that's going to mean the Federal Reserve, some time down the pike, is going to have to raise interest rates even further than their already high, real level in order to squeeze out domestic investment to make room for financing the Federal budget deficit.

Finally, the mounting interest payments on the Federal debt will force an unwanted increase in the future in Federal tax burdens simply to pay interest on the debt. The longer we wait, the larger that ultimate increase is going to have to be.

In short, the consequences of continuing the deficit unchecked in the long term, while subtle and indirect are substantial—and there are three of them: First we are going to have to pay increased debt service abroad, substantial debt service, on the foreign debts we are piling up. That will lower our living standards.

Second, as foreigners ultimately reduce the inflow of savings into the United States, we are going to have to squeeze out domestic investment. And that's going to slow down the growth of productivity. It's going to mean higher interest rates. And that's going to lower our living standards.

And, finally, as we accumulate Federal debt, the future tax burden has to rise. We will have an unnecessarily high level of taxes in the future, and that will tend to lower our living standards.

Again, my judgment is that the problem is not a crisis. It's not a catastrophe. I almost wish it were. We might do something about it more quickly. It is subtle, long term poison.

Let me turn to my second point. To cut the deficit by the necessary large amounts, spending reductions are essential, but they will not be enough; particularly, if we confine them to spending outside of the defense budget and outside of Social Security.

Apart from recession and near recession years, budget deficits in the United States have averaged 1 percent of GNP during the three decades from 1952 to 1981. The net saving of the United States before taking into account the budget deficit is only 8 to 9 percent of GNP. And we are going to be running a budget deficit of 5 percent of GNP, more than half of domestic net savings.

At a minimum, we should aim to get the deficit down to the range of $75 to $90 billion by 1988, which is 1½ to 2 percent of GNP, on the way toward balance by 1990. Such a large cut can't realistically be achieved solely by cutting spending.

Take a look at all Federal civilian spending outside of Social Security, Medicare, and interest on the debt as a percent of GNP. These numbers are on page 11 of my testimony. It's everything the

Federal Government does except defense, interest, Social Security and Medicare. In 1965, that was 6.8 percent of GNP. By 1980, it had risen to 9.3 percent of GNP. By 1988, it will be back down to 6½ percent, were assuming no further cuts beyond last year's Congressional action. That is, as a share of GNP civilian spending, outside of Social Security and Medicare, has already been cut to less than where it was before L.B.J. launched the Great Society programs. Ronald Reagan and the Congress have already brought about something of a revolution here.

Total spending in these civilian programs that I'm talking about will amount to only $325 billion in 1988. The reported administration spending cuts, if the media are correct, would reduce these programs by $65 billion and bring their share of GNP down to below what it was in 1948 and, indeed, below 1940. In my judgment, aiming for such a low target is undesirable, unrealistic, and probably counterproductive in terms of congressional cooperation.

An economically defensible and politically feasible program to reduce the budget well below $100 billion by 1988 requires that all elements, in the budget be involved, including taxes, defense, and Social Security.

Let me just give you one example: Suppose you disallow cost-of-living increases everywhere for 1 year. I would exempt programs for the poor, but that wouldn't make a lot of difference in the budget savings. It doesn't cost very much.

Second, freeze most discretionary Federal civilian spending. I say "most." You would have to make a few exemptions.

Freeze the inflation adjusted level of defense appropriations at the 1985 level. You can't freeze spending, but you can freeze the inflation adjusted appropriations.

On taxes, several possibilities. The best would be to adopt the Treasury tax reform plan, but with personal rates set at a range of 17 to 40 percent and a corresponding change in the corporate rate. You would bring in an additional $60 to $70 billion in revenues by 1988. Taking into account the savings and interest payments which you would then get, this would hit the target of a $70 to $90 billion deficit by 1988.

All four elements across the board.

In summary, the deficit is a very serious economic problem. Spending reductions have to be part of any program to cure it. But alone they won't be enough. I think the approach ought to be across the board.

The CHAIRMAN. I think what we will do is hear from each of the panelists and then we will have questions.

[The prepared written statement of Dr. Schultze follows:]

Outline of Testimony

of

Charles L. Schultze*
Brookings Institution

before the

U.S. Senate Committee on Finance

January 2, 1985

Mr. Chairman and Members of the Committee:

I. Introduction

A. Summary: You have asked me to discuss the economic impact of spending reductions. I will approach the answer to your question indirectly: first by outlining the long-term economic damage that would ensue from failure to deal with the budget deficit, and second by suggesting that spending reductions--while a necessary component of a budget reduction package--are not sufficient to do the job required--i.e., getting the deficit down to a range of $75 - $90 billion by 1988 on the way to balance by 1990.

B. Preview: I will discuss briefly two aspects of how the current and prospective federal budget deficits affect the U.S. economy, and then say a few words about what it will take to deal with them:

1. How the deficits have twisted the shape of the recovery to date.

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*The author is a Senior Fellow at the Brookings Institution. The views set forth here are solely those of the author and do not necessarily represent the opinions of the trustees, officers or other staff members of the Brookings Institution.

2. What are the likely future consequences for the U.S. economy if the deficits are not sharply reduced?

3. All elements of the budget will have to be included in an economically defensible and politically feasible attack on the deficit; including increases in taxes, and cuts in defense spending and social security benefits as well as other civilian spending cuts.

C. Background: Size of the deficit. If nothing further is done to reduce the deficit it will likely:

- exceed $200 billion in 1985, and rise to the neighborhood of $235 billion by 1988;
- remain about 4-1/2 - 5 % of GNP into the indefinite future;
- these forecasts are based on the August 1984 CBO estimates, adjusted to assume a reasonably optimistic 3-1/2% average growth rate for GNP.

II. How the deficits have affected the economy to date

A. Necessary to start with a few words about the policy of the Federal Reserve.

- Given the massive stimulus to demand and spending generated by the huge growth in the budget deficit, the Fed's principal objective, from early 1983 until summer 1984, has been to limit the speed of the recovery in order to keep it from being excessively rapid and thereby threatening renewed inflation.
- Fed was willing to do whatever was necessary by way of a restrictive monetary policy and high interest rate to achieve this objective; indeed it demonstrated its willingness to do so by beginning to tighten monetary policy in May 1983, only 5 months into the new recovery; an unprecedented early date for tightening.

B. Consequences have been a clash of two opposing forces:

- Large upward stimulus to some sectors of U.S. economy from the budget deficits;
- Substantial restraint on other sectors of the economy from Fed's high interest rates;
- The net result has been an overall recovery of about average speed, but with a major twist to penalize interest sensitive sectors of the economy.

C. Another way of looking at the same phenomenon:

- federal borrowing grew to 5% of GNP
- given Fed's objective of preventing excessively rapid recovery, somewhere else in the economy 5% of GNP had to be squeezed out of other interest-sensitive activities by the high interest rates

D. There are only three possible routes by which higher interest rates can crowd out private activity, to make room for federal borrowing of 5 % of GNP:

1. An increase in private saving (i.e., a decrease in consumption) to finance the extra federal borrowing; or
2. A decrease in interest-sensitive private spending
   - 2A. Lower housing construction,
   - 2B. Lower business investment; or
3. An inflow of saving from abroad: i.e., lower exports and higher imports, leading to an inflow of foreign savings into the U.S.

E. Surprising fact about the last two years is that most of the consequences of the deficit have been felt in the foreign sector, i.e., route #3 above

- we have had little increase in private saving as percent of GNP;
- there has been some reduction in housing below normal recovery levels but not large;
- no reduction below normal in share of GNP going to business investment; (1981 tax cuts on business income and reduced prices of capital equipment has, to date, offset the impact of higher interest rates on U.S. business investment).

F. Major effect of budget deficits and high interest rates has been on international sector of the U.S. economy

- High U.S. interest rates (and other factors) led to massive "over valuation" of U.S. dollar abroad--dollar is 30% to 40% overvalued;
- Exports cut; flood of imports into U.S.;
- 1981 U.S. trade deficit $25 billion; 1984 deficit $110-$120; 1985 deficit even larger;
- Mirror image of massive U.S. balance of payments deficit is an equally large inflow of foreign capital and savings into the U.S.
- Inflow of foreign capital and savings into U.S. now equals about 60% of the federal budget deficit;
- Thus, instead of adjusting to the huge federal borrowing with an increase in private domestic saving or a decrease in domestic investment, the U.S. has adjusted through running a huge balance of payments deficit and borrowing staggering amounts from abroad.

G. Consequences of the "twisting" of the shape of recovery:

1. Inflow of foreign saving has "sheltered" U.S. private investment from the effects of the large increase in federal borrowing: foreign savings supplemented U.S. savings so domestic investment didn't have to be

significantly crowded out.

BUT,

2. This has substantially penalized our most dynamic industries--the export industries; e.g., in the 1970s the U.S. was becoming a major net exporter of capital goods--by the end of 1984 that trend had been sharply reversed—25% of U.S. business investment in durable equipment now comes from abroad; foreign markets for our high tech industries sharply curtailed.
3. We have substantially exacerbated the already difficult problem of import-competitive industries
   - distorting the pattern of investment in U.S. industries;
   - generating large rise in protectionist pressures
4. Most importantly, for the long run, we are piling up massive foreign debts on which the nation will have to pay debt-service; our future growth in living standards will be depressed as we pay this debt-service abroad
   - the inflow of foreign saving has enabled the U.S. both to finance a large federal deficit and to keep up the level of private business investment high;

     BUT,
   - most of the fruits of that "sheltered" investment, in terms of increased output and income won't go to U.S. citizens but will have to be used to pay debt service to foreigners.

III. Future economic consequences, if deficit not sharply reduced: 1. Impact on unemployment and inflation

A. Again, cannot consider this question without some further discussion of Federal Reserve policies.

B. Fed now has two major objectives:

1. Primary objective; already outlined earlier: Fed will do anything necessary by way of tight money & higher interest rates to prevent the massive budget deficit from generating an excessively rapid recovery, an overheated economy, and a renewal of inflationary pressures. It has already demonstrated its willingness and ability to do this.

2. But, Fed also has no desire to see another recession. Unlike 1981-82 it will not deliberately put the economy through the wringer of another recession in order to get inflation down further. So long as inflation remains moderate--as it shows all signs of doing--Fed will not stand by and watch economy go into recession.

   - If it appears that monetary restraint has gone too far, that economic growth is slowing too much--as apparently happened this fall--Fed will move to ease monetary policy, lower interest rates, and correct its mistakes--as it has been doing for last several months.
   - Real interest rates are still so high,--even after recent easing--that Fed has very large scope to use monetary policy to correct any mistake or to offset any softening in economy; more so than usually, the Fed is now in a good position to provide counter-recessionary assistance for the economy, should that be necessary to avert a recession.
   - In short, with one possible exception that I will talk about later, Fed will not deliberately pursue restraint to point of recession; it can and will act to avoid any serious recession;

--we could have several quarters of very slow growth,

--but--subject to the one exception--we are unlikely to have recession.

C. The upshot of this is that the large federal deficits, even if left unattended, are <u>not likely in the next several years to generate either recession or inflation</u>

D. Nevertheless, deficits will have <u>other very damaging long-term consequences</u> for U.S. economy

IV. <u>Future consequences of deficit</u>: 2. Slowing the long-term growth of U.S. living standards

A. To date, as discussed earlier, major consequence of huge deficits and correspondingly large federal borrowing has <u>not</u> been to crowd out private domestic investment, but to squeeze out exports, encourage imports and attract a large inflow of foreign savings. The cost has been a massive increase in foreign indebtedness and in future U.S. debt service to foreigners.

B. Two alternative scenarios for the future:

1. <u>Most likely scenario</u>: Foreign investors will <u>not</u> continue to finance U.S. budget deficits indefinitely; foreign savings inflow will begin to shrink:

- Currently foreigners are acquiring $100 billion or more per year in dollar denominated securities; as time goes on, their portfolios get more and more top heavy with dollar assets and the risks they run in case the dollar declines get larger and larger.
- Eventually, therefore, the demand for dollars on the part of foreigners will decline, the value of the dollar will <u>gradually</u> (?)

begin to fall and, after a lag, the inflow of foreign capital into the U.S. will begin to dry up.

- With foreign savings no longer supplementing the limited flow of U.S. domestic savings, the 4-1/2 - 5% of GNP borrowed by the federal government will have to to be diverted from U.S. domestic investment in housing and in business capital formation. Productivity growth will slow, and long-term U.S. economic growth will suffer.
- The Fed will have to engineer another large rise in interest rates to crowd out domestic investment in order to make room, in a noninflationary way, for the large federal borrowing that will be going on year after year.
- With substantially lower domestic investment, the longer-term growth of the U.S. economy will be markedly slowed; improvements in our future living standards and those of our children will be seriously impaired.

2. An alternative less likely but still possible scenario. When foreign demand for dollars begins to recede, and the value of the dollar begins to decline, conceivably it could fall not gradually--as in scenario #1--but precipitously due to speculative forces. The following chain of events could occur:
   - The rapid fall in the dollar necessarily brings with it a sharp increase in import prices and a noticeable rise in the CPI and other inflation indicators.
   - While the Fed, under circumstances of continuing moderate inflation, does not want and can avoid a recession, it might well be willing to subject the economy to a recession in order to contain a new

inflationary threat coming from a rapidly falling dollar.

- In a recession political support for the large tax increases and expenditure cuts needed to deal with the budget deficit would be even weaker than today; dealing with the deficit would be postponed even further into the future.
- Under current budget policies even an average sized recession could give us two years with budget deficits well above $300 billion--further exacerbating already severe problems of rising interest payments on the public debt.

IV. Long-term consequences of the budget deficit: 3. The internal arithmetic of large, continued deficits

A. Let's go through some simple "deficit arithmetic":

- A one year deficit of $200 billion adds $200 billion to the level of federal debt on which we have to pay interest; at average 9% interest rates that adds $18 billion a year forever to the stream of interest payment.
- Two years of $200 billion deficit adds $400 billion to the national debt and $36 billion to annual interest payments, forever.
- Three year adds $54 billion to this stream of interest payments.
- Thus, by postponing action on the deficit for 3 years the first $54 billion of the tax increase needed to deal with the deficit would be wasted--thrown away to pay for the added interest burden that inexorably accumulates by waiting.

B. The ratio of federal debt to GNP, which steadily declined from over 100 percent at the end of World War II, to a range of 25-30 percent in the late 1970s, is now rising again, and rising sharply. Moreover, the growing

federal debt/GNP ratio can't be financed at interest rates of 2 to 4 percent, as it was in the 1940s and 1950s.

C. By 1989, if nothing is done to reduce the deficit, over 40 percent of personal income taxes each year will go for debt service.

- however, "wasteful" we think some aspects of government spending are, we usually get at least something for our tax dollar--but in the case of interest payments we get nothing.

D. There is a loss to the nation from a high tax burden by way of reduced work incentives to work, save, invest, and take risks;
--the burden is far less than the "supply siders" would have you believe;
--but a loss nevertheless.

E. By failing to raise taxes (and cut spending) now, we will simply have to raise them even higher in the future; we don't avoid a tax increase by waiting--we simply postpone it and make it worse, when it does finally come.

In sum: Continuously siphoning off 4-1/2 - 5% of GNP into federal borrowing has depressed and will continue to depress future U.S. living standards in three ways:

1. Initially, it has generated large increases in debt owed to foreigners, so that part of any future increase in U.S. productivity will have to be paid abroad in debt service rather than being available to increase U.S. living standards.
2. Later, as foreign capital inflow shrinks, the deficits will squeeze out U.S. domestic investment and thereby markedly lower the growth of U.S. living standards.
3. Finally, the continuation rapid growth in the ratio of federal debt to

GNP, inexorably generates an increasing tax burden for future taxpayers--which adds its contributions to the growth-depressing effects of the budget deficits.

V. To cut the deficit by the necessary large amount, spending reductions alone are not enough

A. Outside of recession and near-recession years, budget deficits in the U.S. averaged 1 percent of GNP during the three decades 1952-1981.

B. The net saving of the U.S., (before taking account of the federal budget) is only 8-9 percent of GNP. At a minimum we should aim to get the deficit down to the range of $75 - $90 billion by 1988, i.e., to 1-1/2 to 2 percent of GNP--on the way towards balance by 1990.

C. Such a cut cannot be achieved solely by cutting spending, and especially not by confining most of the spending cuts to civilian programs (outside of social security), as the Administration is reportedly about to propose.

1. All federal civilian spending, outside of social security, Medicare, and interest on the debt as a percent of GNP:

1965: 6.8%

1980: 9.3%

1988: 6.5% (assumes no further cuts beyond actions taken in last year's budget decisions)

- i.e., as a share of GNP civilian spending, outside social security and Medicare, has already been cut to less than where it was before LBJ launched his Great Society program; the room for further cutting is small.
- total spending in these civilian programs will amount to only $325 billion in 1988;

- the reported Administration cuts, which reduce these programs by $65 billion, to a total of $260 billion, would bring their share of GNP down to below what it was in 1948, and indeed below 1940; aiming for such a low target is undesirable, unrealistic, and probably counter-productive in terms of Congressional cooperation.

B. An economically defensible and politically feasible program to reduce the budget well below $100 billion by 1988 would, in my judgement, require that all elements of the budget be involved including taxes, defense, and social security.

C. The following package is an example:

1. Disallow cost-of-living increases for one year in all programs including social security; (exempt SSI, AFDC, and food stamps at modest cost).
2. Freeze most discretionary federal civilian spending (a few exemptions needed).
3. Freeze the inflation-adjusted level of defense appropriations at approximately FY 1985 levels.
4. Adopt the Treasury tax reform plan, but with personal rates set at 17, 28, and 40 percent (instead of 15, 25, and 35) and with a corporate rate at 37 percent (instead of 33). This would yield an additional $60 - $70 billion in revenues by 1988.

D. Taking into account the savings in interest payments on the debt, from lower deficits and lower interest rates, this program would get the budget deficit into the $70 - $90 billion range by 1988.

The CHAIRMAN. Dr. Greenspan.

STATEMENT OF DR. ALAN GREENSPAN, PRESIDENT AND CHAIRMAN, TOWNSEND-GREENSPAN & CO., INC., NEW YORK

Dr. GREENSPAN. Mr. Chairman, I would like to focus somewhat on the same issues as those of Charlie Schultze, but first let me track into a slightly different area.

While the strategic purpose of reducing the deficit, as Charlie has pointed out, is to prevent long-term, excessive absorption of private savings and a crowding out of private investment, the short-term tactical purpose is to create in law a fiscal policy which the financial markets perceive as sufficiently credible to drive long-term interest rates down.

There is no need for a pact with the Federal Reserve stipulating that if Congress reduces the deficit the Fed will ease money supply. The markets work very efficiently by themselves. If the average cynical bonds trader begins to perceive that a budget reduction package is not a phoney, the desire to turn a profit can be counted on to drive bond prices sharply higher and long-term interest rates correspondingly lower.

There is clearly a difference, however, in the way bond traders and other participants in the world markets view a reduction in the deficit. A deficit reduction package which is heavily weighted toward tax increases is less likely to induce a marked decline in interest rates than one heavily or solely weighted in the direction of expenditure cuts.

There is a strong presumption in the financial community that an increase in tax rates could just as easily become the base for increased expenditure programs as for reducing the deficit. The argument that the Congress has not historically employed tax increases, to finance increased expenditures, is apparently unpersuasive to the financial community.

The past is likely to tell us little about the future behavior of the Congress when confronted with pressure from constituencies.

It is true that Presidents and the Congress continuously cut tax rates through the 1970's as inflation pushed most taxpayers into progressively higher tax brackets. And Federal receipts as a percent of the GNP of taxable incomes has remained relatively steady during the past couple of decades.

It is argued, therefore, that increased tax receipts have not been the basis for financing new outlay programs. The critical consideration, however, is spending which rose as a ratio to GNP, increasing the structural deficit. Unless the upward pressure on spending is reduced, tax increases will eventually be triggered, since deficits can't increase indefinitely. In that event, taxes are supporting increased spending programs albeit with a time lag.

There can be little doubt that the markets do not expect expenditure cuts ranging up to $100 billion or more annually by fiscal 1988. Should they actually occur, or of more relevance, should they be enacted into law currently in a manner which is credible to the financial community, long-term interest rates are likely to fall by at least 2 full percentage points with short-term rates falling even more.

Thus, even the sharp reduction in purchasing power implied by such a major contraction of the Federal deficit would surely be overridden by increases in effect of demand generated by the marked decline in interest rates.

Most immediately, home building would rise quite significantly, increasing from recent levels of 1.7 million housing starts annually to well in excess of 2 million starts, and perhaps as high as 2.2 million annually at least for a while.

But the more important and lasting impact would occur in the capital goods market. The exceptionally high cost of capital, which has prevailed in recent years, has led to a disproportionate emphasis in investment in short-lived assets. That is, those with quick cash payoffs.

Lowered long-term interest rates would surely propel stock prices higher and lower the cost of equity capital. And the combination of lowered cost of equity and debt would increase the incentive to invest in-plant and other long-lived goods.

Considering the pent-up demand for longer lived investments at lower costs of capital, the expansion could go on for years. This would be especially helpful to those depressed areas of the American economy which build long-lived facilities or the materials which go into them—steel, heavy equipment components, and so forth.

However, to the extent that the increased purchases of long-lived assets are supplied from abroad, little employment would be created here. As long as the dollar continues to rise in foreign exchange markets, large, probably growing, shares of the U.S. equipment market would be foreign sourced. The key remains the exchange rate.

Lowered interest rates to the extent that they are not fully offset by the monetary authorities abroad would bring the U.S. dollar down in foreign exchange markets, and thereby increase the relative cost of imports in the United States.

I should point out, however, that the evidence suggests that only a small part of last year's rise in the dollar was attributable to higher relative dollar denominated interest rates. Most of it reflected a very substantial demand for dollar investments as a safe haven.

Nonetheless, to the extent that dollar exchange rates are brought down, our net export balance will expand especially as it relates to long-lived investments.

A weakening of the dollar will add some upward pressure to the inflation rate, but it is likely to be modest. Over the longer run, the reduced need for the Federal Reserve to accommodate excessively large borrowings by the U.S. Treasury will be far more important as an anti-inflationary factor for the American economy. That assumes, of course, a major success in reducing the budget deficit.

Thank you.

[The prepared written statement of Dr. Greenspan follows:]

Excerpts from the Testimony of Alan Greenspan*

Before the

Committee on Finance
United States Senate
January 2, 1985

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There is a very broad consensus in this country that deficits that now confront us are too large, threaten the economy, and must be addressed as quickly as possible. I know of no one elected to the forthcoming Congress who did not express deep-seated disapproval of budget deficits and support their reduction.

There is, however, far less consensus than appears on the surface. While the Congress may be virtually unanimous in calling for deficit reduction, what the vast majority also implicitly have in mind is imposing taxes on, or cutting benefits to, some other legislators' constituents, or closing down a military base in districts other than one's own. Advocacy of deficit reduction has to mean a willingness to accept a share of the burden of reducing the deficit. If it does not, such advocacy has the trappings of rhetorical nonspeak.

Our political system is clearly biased toward cutting taxes or expanding ostensibly costless benefits to recipients. We have seen enumerable instances of large benefit increases (such as social security in 1972) or tax cuts being whisked through the Congress with virtually no opposition. But cutting benefits or raising taxes is clearly not a symmetrical exercise. Recapturing benefits previously bestowed or burdening voters with increased taxes is not the American political system's greatest strength. Hence, the persistent bias toward increasing federal outlays and deficits.

While the strategic purpose of reducing the deficit is to prevent long-term excessive absorption of private savings and a crowding out of private investment, the short-term tactical purpose is to create, in law, a fiscal policy which the financial markets perceive as sufficiently credible to drive long-term interest rates down. There is no need for a pact with the Federal Reserve stipulating that if Congress reduces the deficit the Fed will ease money supply. The markets work very efficiently by themselves. If the average cynical bond trader begins to perceive that indeed a budget reduction package is not phoney, the desire to turn a profit can be counted on to drive bond prices sharply higher and long-term interest rates correspondingly lower.

There is clearly a difference, however, in the way bond traders and other participants in the world markets view a reduction in the deficit. A deficit reduction package which is heavily weighted toward tax increases is less likely to induce a marked decline in

*Dr. Greenspan is President of Townsend-Greenspan & Co., Inc.

interest rates than one heavily or solely weighted in the direction of expenditure cuts. There is the strong presumption in the financial community that an increase in tax rates could just as easily become the base for increased expenditure programs, as for reducing the deficit. The argument that the Congress has not employed tax increases to finance increased expenditures is apparently unpersuasive to the financial community. The past is likely to tell us little about the future behavior of the Congress when confronted with pressures from constituencies.

It is true that Presidents and the Congress continuously cut tax rates through the 1970s as inflation pushed most taxpayers into progressively higher tax brackets. Hence, federal receipts as a percent of the GNP or of taxable incomes has remained relatively steady during the past couple of decades. It is argued, therefore, that increased tax receipts have not been the basis for financing new outlay programs. The critical consideration, however, is spending, which rose as a ratio to GNP, increasing the structural deficit. Unless the upward pressure on spending is reduced, tax increases will eventually be triggered, since deficits can't increase indefinitely. In that event, taxes are supporting increased spending programs, albeit with a time lag.

There can be little doubt that the markets do not expect expenditure cuts ranging up to $100 billion or more annually by fiscal 1988. Should they actually occur, or of more relevance should they be enacted into law currently, in a manner which is credible to the financial community, long-term interest rates are likely to fall by at least 2 full percentage points with short-term rates falling even more. Thus, even the sharp reduction in purchasing power implied by such a major contraction of the federal deficit would surely be overridden by increases in effective demand generated by the marked decline in interest rates.

Most immediately, homebuilding would rise quite significantly, increasing from recent levels of 1.7 million housing starts annually to well in excess of 2 million and perhaps as high as 2.2 million units annually, at least for awhile. But the more important and lasting impact would occur in the capital goods markets. The exceptionally high cost of capital which has prevailed in recent years has led to a disproportionate emphasis in investment in short-lived assets, i.e., those with quick cash payoffs. Lowered long-term interest rates would surely propel stock prices higher, and lower the cost of equity capital. The combination of lowered costs of equity and debt would increase the incentive to invest in plant and other long-lived goods. Considering the pent-up demand for longer lived investments at lower costs of capital, the expansion could go on for years. This would be especially helpful to those depressed areas of the American economy which build long-lived facilities or the materials which go into them -- steel, heavy equipment, etc.

However, to the extent that the increased purchases of long-lived assets are supplied from abroad, little employment would be created here. As long as the dollar continues to rise in foreign exchange markets, large, probably growing shares of the U.S. equipment market will be foreign sourced. The key remains the exchange rate. Lowered interest rates, to the extent that they are not fully offset by the monetary authorities abroad, would bring the U.S. dollar down in foreign exchange markets and thereby increase the relative cost of imports in the United States. I should point out, however, that the evidence suggests that only a small part of last years' rise in the dollar was attributable to higher relative dollar-denominated interest rates. Most of it reflected a very substantial demand for dollar investments as a safe haven. Nonetheless, to the extent that dollar exchange rates are brought down, our net export balance will expand especially as it relates to longer lived investments.

A weakening of the dollar will add some upward pressure to the inflation rate, but it is likely to be modest. Over the longer run the reduced need for the Federal Reserve to accommodate excessively large borrowings by the U.S. Treasury will be far more important as an anti-inflationary factor for the American economy. That assumes, of course, a major success in reducing the budget deficit.

The CHAIRMAN. Dr. Roberts.

STATEMENT OF DR. PAUL CRAIG ROBERTS, THE WILLIAM E. SIMON PROFESSOR OF POLITICAL ECONOMY, GEORGETOWN UNIVERSITY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, WASHINGTON, DC

Dr. ROBERTS. Mr. Chairman, members of the Finance Committee, the economic impact of spending reductions is positive. There are several reasons why this is the case. There has been much said in recent years about how the private sector is crowded out by the Government sector. The crowding out occurs because Government spending preempts real resources from being used in the private sector where, in general, they are used more efficiently and effectively.

Keep in mind that crowding out occurs regardless of whether the Government finances its spending by taxing or by borrowing. Real crowding out cannot be reduced by raising taxes to reduce borrowing. It can only be reduced by reducing spending.

If real crowding out is a concern, the obvious implication is that spending should be reduced regardless of the deficit. Indeed, spending should be reduced even if there were a surplus in the budget.

Recently published studies show that each dollar of Federal spending reduces private investment by roughly $0.22. It's not only private investment that is crowded out by Government spending. More importantly perhaps, Government spending crowds out incentives and undermines both private property rights and self-reliance.

The longrun effect, basically, is to transform the nature of U.S. society in the direction of a welfare state.

The future depends on the economy growing faster than Government spending. Your goal then should not be defined as a fixed amount of budget cuts, but it should be defined in terms of Government spending declining as a percent of gross national product.

Here your success will be helped or hindered by the performance of the economy. The faster the economy grows, the less you will have to restrain spending growth in order to reduce it as a share of GNP.

The slower the economy grows, the more you will have to curtail spending in order to reduce it as a share of GNP.

Keep in mind that the Federal Reserve Board can easily offset your efforts to reduce the deficit and spending as a share of GNP. For the last 6 months, the Federal Reserve permitted no growth in the money supply as measured by M-1. The slowdown in the economy in third and fourth quarters has added approximately $25 billion to the deficit, and increased spending as a share of GNP.

This means you will have to come up with $25 billion in spending reductions just to stay even. If the Fed follows a slow growth policy or alternatively guns the money supply and then slams on the brakes, back and forth, the Congress will have no effective control over the deficit or over spending.

Considering the central role played by economic growth, spending reduction in the absence of a progrowth tax and monetary policy would require sizeable, absolute cuts in Government spend-

ing or could require sizable, absolute cuts. I doubt that Congress would bring in a budget in which the outlays and the budget authority were less than the previous year. Therefore, you are unlikely to succeed in controlling spending unless you can establish a progrowth policy.

Such a policy would be reinforced and not hindered by spending reductions.

Mr. Chairman, during the late 1960's and early 1970's, European governments failed to restrain the growth of their budgets. Instead, they legislated value-added taxes to finance the growth of government. There is a table at the end of my testimony that shows the large increase in the growth of government was accompanied by a sharp drop in the growth of the economy. I hope that we do not repeat their mistake.

Thank you, Mr. Chairman. That summarizes my testimony.

The CHAIRMAN. Thank you.

[The prepared written statement of Dr. Roberts follows:]

The Economic Impact of Spending Reductions
Testimony before Senate Finance Committee
January 2, 1985
Paul Craig Roberts
Wm. E. Simon Professor of Political Economy
Center for Strategic and International Studies
Georgetown University

Mr. Chairman, members of the Finance Committee, the economic impact of spending reductions are positive. There are several reasons why this is the case. There has been much said in recent years about how the private sector is "crowded out" by the government sector. Crowding out occurs because government spending preempts real resources from being used in the private sector, where in general they are used more efficiently and effectively. Crowding out occurs regardless of whether the government finances its spending by taxing or by borrowing. Real crowding out cannot be reduced by raising taxes to reduce borrowing. It can only be reduced by reducing spending. If real crowding out is a concern, the obvious implication is that spending should be reduced regardless of the deficit. Indeed, spending should be reduced even if there were a surplus in the budget.

In view of the economic facts, it is discouraging that some people want to control government spending only when they work themselves into a fright about the deficit. Too many decision-makers and commentators believe mistakenly that crowding out is primarily a financial phenomenon that occurs because government borrowing raises interest rates and crowds out private investment. In this mistaken view, crowding out can be reduced by raising taxes to reduce the deficit even if spending continues to grow. The view that government borrowing is the main determinant of

real interest rates and private investment is not supported by econometric studies of the empirical evidence to date. One of the first things I did in 1981 as Assistant Secretary of the Treasury for Economic Policy was to initiate a study by the professional staff of the U.S. Treasury of the effects of deficits on interest rates and the prices of financial assets. This study turned into a three year project that was continued by my successor and was published by the U.S Treasury in 1984 under the title, The Effect of Deficits on Prices of Financial Assets: Theory and Evidence. The Treasury study includes all of the academic studies to date. The study makes clear that the simplistic relationship often asserted between deficits and interest rates, and between interest rates and investment, is not supported by the evidence.

If you distrust the results of formal studies, turn to your own experience of the last few years. Despite relentless predictions to the contrary, interest rates fell in the face of large, and even rising, budget deficits, and the prices of financial assets soared. Despite conventional forecasts that large budget deficits would crowd out interest-rate-sensitive sectors of the economy and permit only a weak and lop-sided recovery in 1983, the economy boomed. As the 1984 Economic Report of the President shows, the strong recovery was led by business capital spending, which made an unusually large contribution to GNP growth compared to the typical postwar recovery. Misled by the conventional wisdom, the Reagan Administration, the Congressional Budget Office, and the Federal Reserve Board failed to predict the strength of the recovery.

The reason conventional forecasters were so far off the mark is that they overestimated the effect of deficits on interest rates and investment, and underestimated the effect of the tax reductions which significantly increased the aftertax rate of return on investment. The results of long-term research by myself and former colleagues at the U.S. Treasury show that the effect of interest rates on the cost of capital is small compared to the effect of taxation. These results were recently presented at an international conference and will soon be published.

Mr. chairman, members of the committee, do not misconstrue my testimony as an argument that deficits don't matter. I am saying that spending matters more, and that the adverse effects of deficits differ from the assumptions of the conventional wisdom. The evidence for financial crowding out is weak at best, but the evidence for real crowding out is strong. Recently published studies in Public Choice and Public Finance show that each dollar of federal spending reduces private investment by roughly 22 cents.

It is not only private investment (and consumption) that is crowded out by government spending. More importantly, government spending, particularly transfer payments and entitlements, crowd out incentives and undermine both private property rights and self-reliance. The main problem with the growth of spending is the transformation of the United States from a free society, in which private property rights are respected, to a welfare state, in which the productive elements of society only have a residual claim to what is left of their income and

wealth after all levels of government are finished redistributing it to the politically deserving. As scholars such as Peter T. Bauer have laboriously documented, when governments make the redistribution of income more important than the production of income, people reallocate their energies from economic to political action. The enormous growth in special interest lobbies, which many members of Congress lament, parallels the growth in the proclivity of government to take from some to give to others.

The growth of government has brought about an enormous transformation in the nature of U.S. society. Over most of our country's history, there was neither an income tax nor a welfare system. This was a period during which the economy simultaneously absorbed millions of penniless immigrants, many of whom could not even speak the language, and rapidly reduced the poverty rate. Today poverty has been institutionalized by the government's poverty programs, and the poverty rate no longer declines. In the U.S. today, only the illegal poor--aliens who do not qualify for the government's transfer and welfare programs--are consistently able to work themselves out of poverty. By undermining private property rights, a welfare state restricts opportunities for all on the grounds that otherwise some will succeed more than others. Those who are determined to succeed despite the government, move into the underground economy, and everywhere we see the underground economy growing together with the growth of government. As it becomes more difficult to succeed honestly, criminal activity also becomes more attractive.

The future depends on the economy growing faster than government spending. Your goal, then, should not be a fixed amount of budget cuts but government spending declining as a percent of GNP. Here your success will be helped or hindered by the performance of the economy. The faster the economy grows, the less you will have to restrain spending growth in order to reduce it as a percent of GNP. The slower the economy grows, the more you will have to curtail spending in order to reduce it as a share of GNP. Keep in mind that the Federal Reserve Board can easily offset your efforts to reduce the deficit and spending as a share of GNP. For the last six months the Federal Reserve permitted no growth in the money supply as measured by M1. The slowdown in the economy in the third and fourth quarters has added approximately $25 billion to the deficit and increased spending as a share of GNP. This means you will have to come up with $25 billion in spending reduction just to stay even. If the Fed follows a slow growth policy or alternatively guns the money supply and then slams on the brakes, the Congress will have no effective control over the deficit or spending.

Considering the central role played by economic growth, spending reduction in the absence of pro-growth tax and monetary policies would require sizeable absolute cuts in government spending. This Congress is not likely to bring in a budget in which outlays and budget authority are less than the previous year. Congress, therefore, is unlikely to succeed in controlling spending unless it supports a pro-growth economic policy. Such a policy would be reinforced, and not hindered, by spending reductions.

During the late 1960s and early 1970s, European governments failed to restrain the growth of their budgets. Instead, they legislated value added taxes (VAT) to finance government growth. As the table shows, the large increase in the growth of government was accompanied by a sharp drop in the growth rate of the economy.

THE GROWTH OF GOVERNMENT VS. THE GROWTH OF THE ECONOMY

	Before VAT		After VAT	
Country	Central Gov. share of GDP	Real growth rate of GDP	Central Gov. share of GDP	Real Growth rate of GDP
U.K.	29.6%	3.0%	38.0%	0.8%
W. Germany	24.5	4.7	30.4	3.1
France	29.9	5.6	37.5	3.8
Italy	30.9	5.4	44.5	2.4
Belgium	31.5	4.8	45.6	2.6
Average	29.3	4.7	39.2	2.5

The CHAIRMAN. Dr. Feldstein.

STATEMENT OF DR. MARTIN FELDSTEIN, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH; AND THE GEORGE F. BAKER PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. FELDSTEIN. Thank you, Mr. Chairman. I'm very pleased to appear again before this committee and to have this chance to answer your question about the likely effect of deficit reduction of the magnitude that the administration is considering.

Well, as I said, I'm very pleased to appear before this committee and to have the chance to answer your question about the likely effect of deficit reductions of the sort that the administration has now been talking about.

I strongly support the efforts of this committee and of the administration to identify ways of achieving a substantial reduction in future budget deficits.

The deficit reductions that the administration has set as planning targets, enough to bring the deficit down to 4 percent of GNP in fiscal year 1986, and 3 percent and 2 percent of GNP—in other words, starting with a $40 billion deficit reduction for fiscal year 1986 and increasing to $110 billion in fiscal year 1988—would, if it were firmly embodied in legislation this spring, have very favorable effects on the American economy both in the near-term and the more distant future.

In the short term, the effect of enacting a deficit reduction of that magnitude would be a substantial decline in medium-term and long-term interest rates and in the international value of the dollar. The lower interest rates would mean more investments in plant and equipment, and more housing construction. A more competitive dollar would mean an increase in exports, and a decline in imports. All of that would add up to a more balanced expansion that would last longer and with less unemployment than the lopsided recovery that we otherwise face today.

Changing the financial market's expectations—and that's the key word—expectations—changing their expectations about the size of future deficits is the key to achieving an immediate reduction in medium-term and long-term interest rates. Those are the interest rates that affect business investment and housing starts.

If the financial markets continue to expect that the Government will go on in future years borrowing vast amounts to fund huge deficits, then real interest rates on those bonds and mortgages that stretch into future years will remain high. But if the Congress enacts legislation that convinces financial investors that Government borrowing will decline substantially in future years, real interest rates will decline, and they will decline at once.

In your invitation to testify, you asked how big a decline in interest rates can be expected to follow from legislation that cuts future deficits by amounts starting at some $40 billion in the next fiscal year and rising to $100 billion in 1988, and greater amounts in the more distant future.

An interest rate decline of 2 full percentage points would not be at all surprising. And even larger declines, 3 or even conceivably 4 percentage points, are possible.

To convince yourself that such a decline is a realistic possibility, it's useful to look at the level of real interest rates on Government bonds now and to compare it with that level in the past.

A 10-year Government bond now yields more than 11 percent. Even a pessimistic forecast of inflation would indicate perhaps 6 percent over the next decade. And that pessimistic forecast still implies a real interest rate of 5 percent.

By contrast the real interest rate on such 10-year Government bonds averaged only 2 percent in the decade of the 1960's and less than 1 percent in the 1970's. Since the projected budget deficits are the primary reason for the current high level of real interest rates, a major reduction in future deficits could shrink the real interest rates toward their historic levels.

Let me just comment for a moment on the very significant decline in interest rates that we have seen in the last few months. I think the principal reason for that decline has been the change in inflation expectations. If you think back 6 months ago, we were still hearing a lot from some monetarists that inflation might be up near double digit levels by the end of 1984 or the beginning of 1985, and people were more generally worried that the economy was overheating with 10-percent growth in the second quarter.

But, of course, the actual inflation has come down and the economy has slowed. The worry about overheating is certainly no longer present.

I think that the interest rates have come down because we no longer have in financial markets the same fears that we did 6 months ago that inflation was bound to go on rising in the future.

But that means that real interest rates, that is interest rates adjusted for inflation, have not come down. We have seen the inflation component in the interest rate squeezed a bit. I think it's going to take substantial reductions in expected deficits to reduce those real interest rates in the future. Although it's not possible to predict with precision the size of the interest rate decline that would be caused by a program of deficit reduction, I think we are on firmer ground when we estimate the magnitude of the increase in business investment and housing construction that would result from the deficit reductions that you are now considering. Since the deficit reduction of $110 billion would add nearly $110 billion to the annual pool of funds available for investment, we can predict that total national investment would rise by this amount, even though we don't know just how much of an interest rate shift it would take to bring this about.

Moreover, it's the change in the level of investment rather than the change in the interest rate that is really the important thing to focus on.

To put an increase in an investment of $100 billion into perspective, note that 1988 investment increase of $100 billion would be equivalent of an increase of nearly 30 percent in the overall level of net investment in our economy.

Past experience indicates that housing would get about 40 percent of the resulting rise in net investment. A rise of $40 billion a

year in residential investment would be equivalent to about 400,000 extra housing costs a year, an increase of more than 25 percent from the recent level.

In the near-term, some of the reduction in the budget deficit would not flow into an increase in domestic investment, but instead would cause a reduction of the inflow of investment from abroad. And that would bring with it a welcome decline in our trade deficit.

But since the capital inflow from abroad will inevitably decline in the future, even if no progress is made in reducing future budget deficits, the long-term effect of a reduction in the budget deficit is to increase domestic investment by an essentially equal amount.

The clear implication of what I have been saying is that the proposed deficit reductions would have a very substantial and very favorable impact on the long-term level of net investment, and therefore on the productivity of the work force and on the housing standards of the population.

The deficit reduction legislation that you enact this spring will also have an important impact on the face of economic activity in the nearer term, especially in 1986. If you enact a reliable and convincing reduction in future deficits, the economy can continue to expand at a healthy pace. But if the deficit is reduced in a piecemeal, year at a time way—some legislation this spring, more legislation left over for future years, in that piecemeal way—the result of deficit reduction might very well be an economic down-turn.

Why is the predictability and the reliability of the future deficit reduction so crucial for maintaining the pace of expansion in 1986 and beyond? Let me explain very briefly.

The direct effect of deficit reduction is to contract the overall level of demand, regardless of whether that deficit reduction is achieved by cutting Government spending or by raising taxes and thereby cutting private spending. To sustain the expansion, this reduction in demand must be offset by increases in investment and in net exports.

Fortunately, such increases occur automatically in response to the lower real interest rates and the lower dollar that results from declines in Government borrowing. But—and this is the key—there are significant delays between the time when interest rates and the dollar decline and the time when the resulting increase in investment and net exports reach their full level.

If you are to offset the contractionary effects of deficit reduction and sustain the pace of expansion, the interest rate and the dollar must decline about a year in advance of a substantial reduction in budget deficits.

In other words, the key to sustaining the economic expansion in 1986 and beyond is to convince financial investors this year, in 1985, that Government borrowing will decline significantly in the years ahead. If they are convinced, then interest rates and the dollar will come down this year, and the level of investment and net exports in 1986 will rise by enough to maintain the pace of economic expansion.

Legislation that unequivocally points to substantial and reliable reductions of deficits in the years ahead must, therefore, be the No. 1 legislative priority for Congress this spring.

Thank you.
The CHAIRMAN. Thank you very much, Dr. Feldstein.
[The prepared written statement of Dr. Feldstein follows:]

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CONSEQUENCES OF LOWERING FUTURE BUDGET DEFICITS

Testimony

of

Martin Feldstein

to the

Senate Finance Committee

January 2, 1985
Washington, DC

Embargoed until 10:00 A.M.
January 2, 1985

Consequences of Lowering Future Budget Deficits

Testimony to the Senate Finance Committee
January 2, 1985

Martin Feldstein

Thank you, Mr. Chairman. I am very pleased to appear again before this very distinguished committee. I strongly support the current efforts of this Committee and of the Administration to identify ways of achieving a substantial reduction in future budget deficits. The deficit reductions that the Administration has set as planning targets, starting with $42 billion in FY 1986 and increasing to $110 billion in FY 1988, would, if firmly embodied in legislation this spring, have very favorable effects on the American economy in both the near term and the more distant future.

Interest Rate Decline

The short-term effect of enacting a deficit reduction program of that magnitude would be a substantial decline in medium-term and long-term real interest rates and in the international value of the dollar. The lower interest rates would mean more investments in plant and equipment and more housing construction. The more competitive dollar would mean an increase in exports and a decline in imports. All of this would add up to a more balanced expansion that would last longer and with less unemployment than the lopsided recovery that we face today.

Changing the financial markets' expectations about the size of future deficits is the key to achieving an immediate reduction in the medium-term and long-term interest rates that affect business investment and housing starts. If financial markets expect that the government will continue in future years to borrow vast amounts to fund huge deficits, real interest rates on the bonds and mortgages that stretch into those future years will remain high. But if the Congress enacts legislation that convinces financial investors that government borrowing will decline substantially in future years, real interest rates will decline at once.

How big a decline in interest rates can be expected to follow from legislation that cuts future deficits by amounts that rise from $42 billion in 1986 to $110 billion in 1988 and to greater amounts in the more distant future? An interest rate decline of two percentage points would not be at all surprising. An even larger decline is certainly possible.

To convince yourself that such a decline is a realistic possibility, it is useful to look at the level of the real interest rate on government bonds now and compare it with the level in the past. A 10-year government bond now yields more than 11 percent. Even a pessimistic forecast that inflation will average six percent over the next decade still implies a real interest rate of 5 percent. By contrast, the real interest rate on such 10-year government bonds averaged

only two percent in the decade of the 1960's and less than one percent in the 1970's. Since the projected budget deficits are the primary reason for the current high level of real interest rates, a major reduction in future deficits could shrink the real interest rates toward their historic levels.

Increased Investment and Housing

Although it is not possible to predict the size of the interest rate decline with precision, we are on firmer ground when we estimate the magnitude of the increase in business investment and housing construction that would result from the deficit reductions that you are now considering. Since a deficit reduction of $110 billion would add nearly $110 billion to the annual pool of funds available for investment (with the shortfall from $110 billion reflecting the increase in interest sensitive components of consumer spending), we can predict that total national investment would rise by this amount even though we don't know the size of the interest rate change that will occur to bring this about.

To put such an increase in investment into perspective, note that a 1988 investment increase of $100 billion would be equivalent to an increase of nearly 30 percent in the overall level of net investment in our economy.

Past experience indicates that about 40 percent of the resulting increase in net investment would be in housing. A

rise of $40 billion a year in residential investment would be equivalent to an additional 400,000 housing starts a year, an increase of more than 25 percent from the recent level of housing starts.

In the near term, some of the reduction in the budget deficit would not flow into increased domestic investment but would instead cause a reduction in the inflow of investment capital from abroad -- and therefore a welcome decline in our trade deficit. But since the capital inflow from abroad will inevitably decline even if there is no progress in reducing future budget deficits, the long-term effect of a reduction in the budget deficit is to increase domestic investment by an essentially equal amount.

The clear implication of what I have been saying is that the proposed deficit reductions would have a very substantial and favorable impact on the long-term level of net investment and therefore on the productivity of the workforce and on the housing standards of the population.

A Smooth Transition?

The deficit reduction legislation that you enact this spring will also have an important impact on the pace of economic activity in 1986 and beyond. If you enact a reliable and convincing reduction in future deficits, the economy can continue to expand at a healthy pace. But if the

deficit is reduced in a piecemeal year-at-a-time way, the result of the deficit reduction might very well be an economic downturn.

Why is the predictability and reliability of the future deficit reductions so crucial for maintaining the pace of expansion in 1986 and beyond? Let me explain.

The direct effect of deficit reduction is to contract the overall level of demand, regardless of whether the deficit reduction is achieved by cutting government spending or by raising taxes and thereby cutting private spending. To sustain the expansion, this reduction in demand must be offset by increases in investment and net exports.

Fortunately, such increases occur automatically in response to the lower real interest rates and lower dollar that result from the decline in government borrowing. But there are significant delays between the time when interest interest rates and the dollar decline and the time when the resulting increases in investment and net exports reach their full levels. To offset the contractionary effects of the deficit reduction and sustain the pace of the expansion, the interest rate and dollar must therefore decline about a year in advance of a substantial reduction in the budget deficit.

The key to sustaining the economic expansion in 1986 and beyond is therefore to convince financial investors in 1985 that government borrowing will decline significantly in the

years ahead. If they are convinced, then interest rates and the dollar will come down this year and the level of investment and net exports in 1986 will rise enough to maintain the pace of economic expansion.

Legislation that unequivocally points to substantial and reliable reductions of budget deficits in the years ahead must be the number one legislative priority for Congress this spring.

Thank you.

The CHAIRMAN. Before we start the questions, Senator Wallop, do you have any statement you would like to make?

Senator WALLOP. No, Mr. Chairman.

The CHAIRMAN. If not, I will yield first to Senator Packwood, the incoming Finance Committee chairman who will help put together this package and who suggested these hearings.

Bob.

Senator PACKWOOD. I notice that Dr. Roberts is the William E. Simon Professor of Political Economy at Georgetown. I talked to Bill Simon last week and I posed to him the same question that was asked of this panel. That is, assuming we do cut $42 billion of spending out of next year's budget, $85 billion the following year, and $110 billion a year after that, what would be the effect on interest rates? His answer was very similar to that of Marty Feldstein. He said a minimum of 2 percent, a minimum. He was much more bullish about 3 percent or greater. I asked if I could make that statement publicly, and he said, "Yes." He couldn't be here today, but he was happy to have that on the record.

But, Charlie, I think we are going to try something we haven't tried before. This President is very serious about spending cuts. And we are not talking about $200 million off of welfare and $300 million off of foodstamps. He is talking about Pac-Man gobbling up programs and eliminating them.

The end of Amtrak. The end of the Corporation for Public Broadcasting, possibly. The end of the Small Business Administration and the Economic Development Administration. Those are tough cuts. And those are not poverty program cuts. It is not the poor that ride Amtrak. Those are middle income programs that have solid, middle-income Republican constituencies.

To get this Congress to adopt those kind of cuts, there is going to have to be a trade-off in the public's mind. And that trade-off is reducing interest rates.

If Congress actually puts into place spending cuts of sufficient magnitude, and I don't mean a 1-year freeze, which would save about $42 billion the first year, to cause you and Marty, Paul and Alan and everybody else to say, "By golly, they have done it," could we expect reductions in the size of 2 to 3 percent in interest rates?

Dr. SCHULTZE. I'm very leery about giving numbers, but it would be a substantial magnitude. As a first approximation, and only a first approximation, if you take $110 billion out of the defense budget or you take $110 billion out of the Social Security budget, or you take $110 billion out of any set of budgets, it will have a major impact, so long as it's believable. That is, if it's legislated in a way that it's believable.

Senator PACKWOOD. You mean it can't be a mere promise to do it next year?

Dr. SCHULTZE. That's right. It would then have, I believe, a major impact. I think some of the cuts that presumably the President will propose are good cuts. Budget directors have been trying to get them for 30 years, at least. I haven't researched back further than 30 years. I remember some of them myself.

Some of them, I think, are questionable. Some of them, I think, are outrageous.

Senator PACKWOOD. But it doesn't make any difference, within reason, what the cuts are.

Dr. SCHULTZE. The economic impact of them has little to do with their equity, fairness, who they hit. You will get interest rates down. Now I think it is very important, very important, that the Congress not make a great big run at this and fall on its face. The damage that could be done—and Marty is quite right, Alan is quite right—to markets in terms of does the Congress, the public, everybody have the guts to do this. Well, really it would be bad if it falls on its face. That's one of the reasons that I would hope that before anybody hangs or pins all their colors to a set of cuts out of civilian programs outside of Social Security and defense—people worry about what happens if you fail.

Dr. FELDSTEIN. I might just say one further thing about the decline in interest rates. This may explain why Charlie and I and others are a little reluctant to talk about the precise number that it will fall because it's a question of compared to what.

If no action is taken, interest rates will go up. They won't just stay where they are. They will get higher. They will get higher because over time we can be pretty sure that the rest of the world is not going to go on supplying capital to the United States at this rate.

Senator PACKWOOD. The premise of my question is interest rates from where we are now. If we actually make those budget cuts and enact them into law in the late spring or early summer, what will happen to interest rates?

Dr. FELDSTEIN. Well, I said 2 percent but with a good deal of hesitation. I think the question that ought to be in people's minds is in comparison to where those interest rates would otherwise be. And I think that the risk is, without action, with the foreigners pulling out their inflow of capital in the future, we would see interest rates going up so that getting them down a percent or 2 percent from the current level is an even bigger fall relative to what we might otherwise be facing.

Senator PACKWOOD. Alan.

Dr. GREENSPAN. I will address that subject, too, but first let me address the question of whether it matters where the spending cuts are. The inflation premiums embodied in those long-term interest rates are essentially the markets' forecast of expected inflation through the full maturity of the debt instrument, 10, 15, 20 years.

And while we are focusing on expenditure cuts through, say, 1988 or 1989, the markets implicitly, even though they don't understand exactly what these numbers may look like, are looking well beyond that. And there is a difference between such things as defense and entitlement programs. Entitlement programs are largely a function of those demographic changes which affect individual programs. We know that Social Security, Medicare, and Medicaid, are going to be expanding programs indefinitely.

Defense, however, is largely a batch process. It is certainly true that operation and maintenance expenditures and personnel expenditures are ongoing and growing outlays. But procurement costs are gross additions to a stock of capital assets. And when we are building, as we are today, a very substantial expansion in what is clearly our depleted defense resources, we are moving ever closer

to the point when gross additions to a stock of F-16's and 15's and 14's and various different missile components will reach a maximum. At that point, procurement will start to decline.

And the reason that we find historically that defense goes up and down as a percent of the budget and the GNP, unlike the other programs, is that we don't have this continuous demographic push, so to speak, which affects other programs.

So a cut which takes out an average of, say, $20 or $30 billion yearly from defense over the next 5 years is given much less credit in the financial community than a comparable dollar amount in entitlement programs which would create a much larger reduction in the years 1995 and 2010 than defense would.

So it's important not to assume that Federal expenditures, so far as this question of expectations of inflation, and therefore interest rates, are concerned, are homogeneous. I don't believe that they are.

Senator PACKWOOD. Dr. Roberts, I'm curious. I read your statement. I understand your theory of what you are saying, but will you address yourself to this specific question? If we make those specific cuts of those amounts, what do you expect interest rates to do?

Dr. ROBERTS. As long as, Senator Packwood, you are talking about spending reductions, then I certainly would agree that it would have a favorable impact on interest rates.

Senator PACKWOOD. Do you want to quantify it?

Dr. ROBERTS. Well, there are so many other factors that could even be more important. And as I pointed out, the Federal Reserve, which is independent in its behavior, if it were to choose to pursue a very low growth strategy, you could find that you wouldn't get the gain economic-wise of your lower interest rates that you would expect from this to make the whole effort worthwhile.

So there are so many ways that this thing could work out that unless I gave you a whole set of different assumptions and we plot each one through—but I'm certainly prepared to support the other people testifying and to agree that if you actually cut spending, real interest rates would fall.

Senator PACKWOOD. A last question. I don't want to leave this with what I thought Marty and Charlie said.

I understand if we do nothing, the interest rates might go up 3, 4, or 5 percent. Are you saying that if we cut spending, instead of going up 3, 4, or 5 percent, it might go up 1 or 2 percent? Or are you saying that if we actually cut spending, we can hope for a reduction from where we are now?

Dr. FELDSTEIN. I think we can hope for a reduction from where we are now.

Senator PACKWOOD. Charlie.

Dr. SCHULTZE. I'm trying to think of the right verb. I think so. The one worry is one Marty got to, I got to, and I don't know how to quantify it in terms of interest rates. And that is some day down the pike that inflow of foreign savings is going to shrink and interest rates are going to go up.

Clearly, you are going to be a heck of a lot better off, if you have a budget deficit below $100 billion. Clearly, you will have lower interest rates. Now how much that is going to be lowered—you only

take it down to $90 billion instead of zero, I'd hate to get myself on record.

I guess I will say this. If you did anything that was credible to pull the deficit down by $110 billion by 1988, this session, I think you will this session see lower interest rates. What I can't guarantee is down the pike they wouldn't go up again.

Dr. GREENSPAN. I think we are being much too cautious, gentlemen. The financial community is so dubious, that if anything of significance is done on the expenditure side especially, and the deficit side in general, they will be shocked. Interest rates will fall significantly if the types of expenditure cuts we are talking about are, in fact, enacted.

And while I do agree with Charlie that there is a short-term problem on the international flow question, clearly if there is a drop in the propensity to invest in the United States, it does put upward pressure on interest rates. But that's only for a limited period of time. It is only during the period of time when the current account deficit, is brought down to more manageable proportions or obversely that the flows into the United States are brought down to more manageable proportions.

When they are brought down to those levels—and that may take 6 months or a year or a year and a half—then that bubble in interest rates that occurs on international account disappears, and the fundamental forces which then drive interest rates are domestic. And in that case, I would argue that the budget deficit, and the expenditure question, becomes the key for interest rates. And, therefore, for where the economy will be over the next 5 years.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Let me go to Senator Moynihan, Charlie.

Senator MOYNIHAN. Mr. Chairman, we've heard some very fine statements and I think they define the situation that Mr. Packwood is going to have to preside over. You got out just in time, Mr. Chairman, as you say.

There is an elementary factor of democratic processes that they have shorter time perspectives than other. It was noted years ago that in Athens, it tended to be under the dictators that they planted olive orchards. It takes 25 years for an olive orchard to bear.

We are going to have to make decisions here that have long-term consequences very much against our normal 2 year cycles.

But I would just like to ask a few questions. And if I say something that anybody disagrees with, just disagree. And no hidden agenda. I'm just trying to get out some baselines.

On the question of entitlement programs, entitlement programs do not now add to the deficit. And assuming that the Medicare funds are put in shape by the end of this decade, the funds will be in surplus by the 1990's and a very considerable surplus. That is the case. And, indeed, if you look out long enough you see large surpluses by the end of the 1990's.

So if we may cut entitlement expenditures—not for the purpose of cutting the budget deficit—it will just cut further——

Dr. GREENSPAN. I think it's the other way around, Senator. In other words, if you cut entitlement programs in the unified budget, you will reduce the budget deficit.

Senator MOYNIHAN. That's right. But as such, they do not contribute to the deficit.

Dr. GREENSPAN. But cutting them would reduce.

Senator MOYNIHAN. Cutting them would reduce.

Now Dr. Roberts has made the point about our level of spending, and made a point that whether you tax or whether you borrow it has the same effect on private investment. The crowding out effect is equal or comparable. And Dr. Roberts suggested that as government spending increases, a society becomes less free.

Now it is the case that in the 1970's the Federal Government budget outlays, as a percent of GNP, stayed at about 20 percent. The budget outlays in 1970 were 20.2 percent and in 1979, at the end of the decade, 20.8 percent. In the years since, they have gone up to almost a quarter. They were a quarter in 1983. They were 24 last year. They will be about a quarter now.

So there has been, I think economists say, a structural change in what is the normal level. We have gone to 25 percent. And the proposition is whether we make up the deficit by taxing or by borrowing—it won't change the impact on the economy while that level of 25 percent remains.

We have already heard Dr. Schultze say that the spending on domestic programs will be lower in 1988 as a percentage of the budget than it was before the Lyndon Johnson era. Where are you going to get this money?

Well, one of your distinguished predecessors, Dr. Herbert Stein, on April Fool's Day a year ago, said "repudiate the debt," in the Wall Street Journal even. But he wasn't really being very serious.

Are you going to be able to get serious cuts out of domestic spending when they will soon be down to where they were during the Kennedy administration when Senator Dole said the whole budget hadn't reached $100 billion?

Dr. ROBERTS. Senator, I don't know what you will be able to achieve. I wish you good luck. My point of view, if I were a participant in the process, is I would say, well, look, let's bring in a budget in which the outlays grow slower than the projected growth of the economy. That's the way I would make up the budget. I would say, well, if we are forecasting an 8-percent economic growth then let's bring the budget in below that.

Senator MOYNIHAN. Those are projections, you know. That's just a number that somebody puts down on a piece of paper.

Dr. ROBERTS. I know.

Senator MOYNIHAN. Outlays can be real.

Dr. ROBERTS. And I'm afraid there would be a tendency to overestimate the economic growth in order to overestimate the budget numbers. That's true. But if you wanted to do it in a way that would work, it would be to keep the growth of the budget slower than the growth of the economy. If you can do that, you can get control of this process. There is no doubt about it.

And I think if you simply started on this path it would reassure the markets and everyone else who allegedly needs reassuring.

Senator MOYNIHAN. When you are borrowing money to pay interest, you have no control over it.

Dr. ROBERTS. Well, we borrowed money to pay interest many times in our history. And as large as the debt is now, it's still

smaller as a share of the economy than it was in the years after World War II. So despite the huge amount of public——

Senator MOYNIHAN. The years after World War II are special.

Dr. ROBERTS. But the economy did very well despite the huge debt buildup. And we are now panicking about a debt which is not as large in relative terms. It doesn't mean I'm in favor of debt.

Senator MOYNIHAN. We had the largest deficit in history but we had no debt problem.

Dr. ROBERTS. What I'm pointing out to you is that the economy did very well at a time when relatively speaking the public debt was the worst burden.

Dr. SCHULTZE. You had a 2½-percent interest rate.

Dr. ROBERTS. That was a result of the Federal Reserve. The Federal Reserve enforced that interest rate.

Dr. SCHULTZE. That's right. With the inflation we then had.

Several points. No. 1, right now as a nice round number, the deficit is 5 percent of GNP. Spending is not any longer scheduled to grow any faster than GNP. If, indeed, you simply had a policy which let spending grow as fast as GNP from the current level and revenues, which they would very roughly grow along with GNP, you will forever have 5 percent of GNP in the deficit. You first have to have a big expenditure cut. Then you set things so that they grow proportionately with GNP. But obviously if you want to get rid of the deficit, you can't start that way.

Dr. ROBERTS. I said "less," Charlie. Let the budget grow slower than the economy. That's what I said.

Senator MOYNIHAN. Well, Mr. Chairman, can I hear from Dr. Greenspan and Dr. Feldstein on that proposition? It just doesn't seem to me the numbers are there in the way we are talking. Where are the cuts that you are talking about and where do we have to go?

Dr. FELDSTEIN. I don't think you can get all of the spending cuts just out of domestic budget, excluding Social Security and Medicare. And it was the domestic budget, excluding Social Security and Medicare, that Charlie Schultze was talking about when he said the share of GNP has come back to where it was in the early 1970's.

Dr. SCHULTZE. Mid-1960's.

Dr. FELDSTEIN. Or the mid-1960's. We are still a percentage point or above where we were in the early 1960's.

But the big increase has come in the area of Medicare and Social Security. That was 2 percent of GNP in 1960. It is heading for 6½ percent of GNP, close to 7 percent of GNP, by the end of this decade. That's where all the growth of Government spending has been.

Senator MOYNIHAN. But it does finance itself.

Dr. FELDSTEIN. Well, total taxes do not cover total spending. We have an earmarked tax for the Social Security and Medicare program which finances those programs. But if we slow the growth of Social Security and Medicare, then we can reduce the overall budget deficit. And if you ask where are the possibilities for reduction, some of them are in the rest of the domestic budget, but some of them are, I think, in Social Security and Medicare.

As far as the rest of the budget goes as a share of GNP, it has come back down very dramatically. But in terms of real dollars, in terms of dollars adjusted for inflation, it's approximately doubled since 1965 so that some of those parts of the Government naturally increase over time as we become more affluent and more numerous.

But other parts ought to decrease as we become more affluent and other parts need not grow with the size of the population. So there is scope, I believe, for cutting the domestic spending exclusive of Social Security and Medicare.

Senator MOYNIHAN. Mr. Chairman, my time is up, and I thank you.

Dr. GREENSPAN. Could I just respond to your question, Senator?

Senator MOYNIHAN. Yes.

Dr. GREENSPAN. I think it's important to distinguish between the immediate post-World War period and the current period. Professor Roberts is certainly correct that aggregate Federal debt as a percent of the GNP was quite high immediately following World War II when we had an explosive increase in Federal debt. However, in the immediate post-World War II period, the rate of increase in the Federal debt was very low and hence debt began to fall as a ratio to the GNP. The contemplated rate of growth in interest payments was falling as a consequence.

The difference now is we are getting to a point where we have an arithmetical dilemma in the sense that at some specific level of the deficit—if $200 billion is not the required number, use $500 billion, you get an explosive expansion in the ratio of Federal debt to the GNP, and an explosive rise in interest payments which in turn——

Senator MOYNIHAN. The situation becoming unstable.

Dr. GREENSPAN. It's an unstable situation. And I think we are on the edge of that.

Senator MOYNIHAN. I think we are on the edge——

Dr. GREENSPAN. I think we are on the edge of moving into an unstable situation. We are not there yet. In other words, we are not now in a position where projections of the current services deficit, and therefore the level of the debt are not at an explosive rate where interest payments become cumulatively unstable. If, however, we move from $200 billion to $300 billion and move the Treasury bill rate as a consequence, probably to 15 or 20 percent, then the fiscal system becomes extremely difficult to restrain.

It's that process which I think is the real danger in this whole budget deficit issue. Its one which is capable of being fended off now but would be exceptionally more difficult to do, say, 2 years or 4 years from now.

Senator MOYNIHAN. Mr. Chairman, could I just repeat that in sum?

The CHAIRMAN. Yes.

Senator MOYNIHAN. We may be at a point where the payment of debt service becomes unstable, goes out of control, and cannot be retrieved under the current monetary system. It seems to me that's a very powerful statement by Dr. Greenspan, Mr. Chairman. Thank you.

The CHAIRMAN. Do you want to comment on that, Dr. Roberts?

Dr. ROBERTS. I was just going to respond to Senator Moynihan about the payroll tax and Social Security. Many economists would be prepared to argue that even though Social Security is currently self-financed, that the payroll tax rate is sufficiently high that it reduces employment, and thereby contributes to the general budget deficit in that way. So it doesn't fit the neat category.

The CHAIRMAN. Could I just ask a couple of questions? And then I will move on to other colleagues.

Is it fair to assume that the financial market has less than total confidence in the Congress? [Laughter.]

Dr. GREENSPAN. I think that's fair.

The CHAIRMAN. Anybody who has any confidence in Congress please stand up.

That seems to be the biggest hurdle. But as I just listened to the testimonies or the statements of those witnesses, plus the statements we have made up here, it would indicate to me at least there is some hope of a strong bipartisan push. I know that in itself isn't going to solve anything, but we have to have some action.

Dr. Feldstein says we have to do it in a certain way. I'm not certain just how it may come out. David Stockman has a plan that the President has yet to sign off on. Others will have plans. But it seems to me that the climate is pretty good. Now it's very early. It's only January 2. And we haven't met yet. It could change in 2 or 3 weeks or 2 or 3 months.

How much time do we have to make this all happen? If you are going to put a timeframe, when should Congress act? By July, August, September? Does it make any difference?

Dr. GREENSPAN. I would say, gentlemen, that probably your side of the table is far more capable of answering that than our side. It's when the next election campaign begins.

The CHAIRMAN. That's after Labor Day, I assume. Probably started in some States already, Kansas and others. [Laughter.]

Dr. Feldstein.

Dr. FELDSTEIN. I would certainly like to see it done by the summer. What worries me, as I said in my prepared remarks, is deficit reduction itself tends to put a damper on the economy. You need to offset it by convincing financial markets that it's not only beginning but that it's going to be sustained. And you've got to do it in advance. You can't wait until just before the deficit starts to shrink. We are talking about fiscal year 1986 as the first year in which to take a big bite out of this deficit. You want to get the interest rates down 6 months, 9 months in advance of that so that investment and export can pick up. There is that lag between the time when interest rates drop and when it shows up in a substantial increase in investment and a substantial increase in exports.

And that's why waiting until the end of the calendar year and then taking a big bite out of the 1986 deficit is a very dangerous strategy, the kind of strategy that could easily push the economy into recession in 1986. The key is to get it done earlier and in a way that is convincing as possible to the financial markets.

The CHAIRMAN. Charlie.

Dr. SCHULTZE. Well, the last thing I want to do is suggest that speed isn't essential and that the deficit isn't the country's overriding problem. On the other hand, you know, sometimes the best can

be the enemy of the good. And I believe there is enough flexibility on the part of the Federal Reserve to bridge over any temporary transition period. So I wouldn't be terribly worried even if the economy were softening later on in the year before you acted. I still wouldn't be worried about going ahead and doing it anyway.

It's not as if we had 2 percent interest rates and the Fed didn't have much room to push them down further. We have, depending on how you measure it, 5, 6, 7 percent real interest rates. There is a lot of room for the Federal Reserve to offset any transitional consequences of your acting on the budget deficit even in a temporarily weak economy. So that, yes, of course, act in a hurry, but if you happen to be late, then don't close up shop and say, "Oh, well, we are late, we missed it." And also don't say—I almost hesitate to say this because we have had too many half loaves and I hope to the Lord we get a full loaf, but even so a half loaf is still better than no loaf, even on the deficit.

Now I do not mean that to suggest that you wouldn't be concerned about doing at least a hundred and some billion off the deficit by 1988. But it isn't as if you have got to have the timing exactly right and the amount exactly right.

The CHAIRMAN. I think we can handle that last part on the title. But I do think there is an urgency. And that is the point I wanted to make. Not an urgency in the sense that we do it in the next 60 days, but certainly in the next 6 months. It would seem to me that after that it gets more and more difficult because we are not in session in August. And then I think we are in an election cycle after Labor Day.

I wouldn't want to be the one to raise revenues in this hearing, but I guess if you found a case where there was a big loophole out there that ought to be addressed, that would be fair game in any package. Does anybody support loopholes here? [Laughter.]

Dr. GREENSPAN. We just support incentives.

The CHAIRMAN. Incentive. I understand the difference. In fact, I read about those in Dr. Roberts' book where I was probably mentioned on every other page.

But it does seem to me that the President has made it very clear. We are only going to look at revenues as a last resort. And I think that's it. I don't know when the last resort comes, but I think Charlie indicated it probably would come. And I'm not here to suggest it or advocate that point of view, but I think we have to be very serious about what we propose to do. And I would hope—and I know the chairman of this committee and Senator Long and other members of the committee are going to be working as quickly as they can.

Another thing that concerns many of us is the high value of the dollar. I'm not sure you addressed that specifically, but would it be fair to say that if we did do some responsible work on the deficit that that might properly moderate the strength of the dollar, which would be of some help to farmers and others that I can think of?

Does anybody disagree with that?

Dr. ROBERTS. I don't think you could take it for granted because the assumption is that the strength of the dollar is due to high interest rates due to big budget deficits. If that assumption is

wrong—in my view it is—then reducing the deficit does not weaken the dollar. It might even strengthen it.

I would like to point out for the record that according to the actual balance of payments statistics, at least as reported by the Treasury, there seems to be a certain amount of misinformation about huge inflows of foreign capital that are financing our deficit. If you actually look at the figures, you don't see any real change in the inflow of foreign capital in the United States. For example, in 1983 it actually dropped below the 1982 level. And in 1984, based on annualizing the first two quarters, it's running at about the rate it was in 1982.

What has happened has been an extraordinary decline in U.S. capital outflows. That is, the U.S. demand for foreign currency accounts has collapsed. So the money is staying at home and financing our own deficit. And you have to ask yourself why is this money staying home. If you look at the figures—for example, in 1982, the U.S. capital outflow was $119 billion as compared to an inflow of foreign capital into the United States of $95 billion.

In 1983, the U.S. capital outflow dropped from $119 billion to $49 billion. The foreign capital inflow also dropped, but from $95 to $82.

In 1984, based on annualizing the first two quarters, the U.S. capital outflow is $57 billion, which is still less than half of what it was in 1982.

Now some people are of the opinion that what basically happened was the tax rate reductions improved the rate of return on real investment in the United States on an after-tax basis, and money quit leaving the country.

The CHAIRMAN. I'm going to have to surrender my time. Go ahead.

Dr. GREENSPAN. Most of that decline in net capital outflow is banking community data, essentially U.S. parent bank flows to affiliates abroad. To a substantial extent it's the pulling in, as I recall, of the Latin American credit expansion starting in the second quarter of 1982. I think that's most of it, but the point you are raising is well taken.

Dr. ROBERTS. Alan is right that some of this is changing as a result of the banks' bad experience with Third World loans. But, nevertheless, the loans to the Latin American countries have risen.

The CHAIRMAN. I think the bottom line is that I think there is concern about the deficit, although there are some Republicans who are no longer concerned about deficits. But most of us are. We consider ourselves to be traditional conservative Republicans and we want to get it reduced. And we have been joined by many, many on the other side of the aisle who have these same attitudes.

I have just read Senator Baucus' statement, which I think is an excellent statement.

And I'm now prepared to yield.

Senator BAUCUS. Thank you, Mr. Chairman. Gentlemen, I will ask a series of questions. We don't have a lot of time here and I hope you will keep the answers really short.

The first question I'm going to ask each of you is: How much do you think from an economist's point of view—that is, strictly from the point of view of should we reduce spending the first year, and

by how much should we reduce spending by the end of the third year? Just give me some rough dollar estimates.

I'm going to start with you now, Dr. Feldstein.

Dr. FELDSTEIN. I'd like to see the deficits on a path that brings them down to 2 percent of GNP in 1988 and a balanced budget in 1990. I would like to see you do as much of that as you can by reduced spending, but I suspect the taxes are going to have to be a significant part of it.

Senator BAUCUS. Roughly by what proportion should that deficit reduction be on the spending side?

Dr. FELDSTEIN. I can't really give you an answer to that.

Senator BAUCUS. All right. Dr. Schultze.

Dr. SCHULTZE. I can't give you an answer on the number you ought to aim for on spending. But, you can't do it all by spending cuts.

You ought to aim at a minimum for getting the deficit down to somewhere between $75 and $90 billion. That is, well under $100 billion by 1988. I don't know what the new numbers are going to look like on deficit projections when the CBO and the administration stop wrestling around, but I'm going to say they are going to be like $225 billion you have got to come down from.

Now some of that you automatically get from saving interest.

Senator BAUCUS. Right.

Dr. SCHULTZE. But if you froze all entitlement programs including the Social Security in the sense of a 1-year moratorium on COLA's, everything—I would exempt the poor—and freeze defense appropriations in inflation adjusted terms, my rough estimate is you will take $50 billion out of spending in 1988. And I think if the Congress could do that and then something around the same number on tax increases or a little bit more, you would really be home.

Senator BAUCUS. All right. Dr. Roberts.

Dr. ROBERTS. Senator Baucus, I will emphasize once again that if you were to, for example, take a——

Senator BAUCUS. If you could give me a dollar amount. This year and also in 3 years.

Dr. ROBERTS. It wouldn't do any good. Suppose you said you are going to cut it $50 billion a year? It may or may not reduce the deficit, if that is your concern, depending on how the economy grows.

Senator BAUCUS. We can't control the Fed. We are sitting here meeting today and we have to make some decisions. I'm trying to determine what those decisions should be. Otherwise, I shouldn't even be here.

So what is just your best judgment on this?

Dr. ROBERTS. That's the whole point. If you want to reduce the deficit, and if you want to reduce spending as a share of GNP, you have to do it in relation to the performance of the economy.

A recent study by the Congressional Budget Office, which I reported on—I don't remember the exact figures, but it showed, for example, that a 1 percentage point higher real economic growth rate had about twice the effect on deficit reduction——

Senator BAUCUS. I'm sorry. I've got lots of questions here.

Dr. Greenspan, could you give me a dollar amount, please?

Dr. GREENSPAN. I would say at least $110 billion on the expenditure side by fiscal 1988 on the grounds that I think the problem is so large that it is almost impossible to overdo the reduction as far as the economy is concerned.

Senator BAUCUS. So you would say roughly by $110 billion or more by 1988.

Dr. GREENSPAN. That's annual.

Senator BAUCUS. Annual reduction?

Dr. GREENSPAN. That's right. Annual, by 1988.

Dr. ROBERTS. Another recession would wipe out the effect of that on the deficit.

Senator BAUCUS. Another series of questions is: Strictly from the point of view of an economist, trying not to put political value judgments into your answer, which I know is going to be tough in some cases—but the question is--and I know Dr. Greenspan thinks it does make a difference between defense and COLA's as to where. The real question goes to the mix of the spending cuts. As economists, can you all generally agree with the proposition that if you cut x dollars in each next several years that from an economist's point of view that the value of the dollar and interest rates and so forth—it doesn't make that much difference what the spending cut mix is? Do you all agree with that or is there a substantial disagreement?

Dr. FELDSTEIN. I would associate myself with Alan's general proposition. That what matters in all this is what people think is going to happen in the more distant future; not just the next couple or 3 years, but what is going to happen out to the end of the century.

Some kinds of changes in spending are more likely to be permanent than others. When you change the COLA's in an entitlement program or you zero out an entire program, then that leads to the expectation of a more permanent reduction in spending than 1 year changes in defense spending that could easily bounce back up again.

Senator BAUCUS. You think the expectation of the financial market is more significant to cut something like COLA's because of the out-year implications and something else.

I see Charlie shaking his head.

Dr. FELDSTEIN. I don't know how strong to be about that, but my sense is that there is a difference.

Senator BAUCUS. Thank you.

Dr. SCHULTZE. Give or take a nickel, a dollar is a dollar is a dollar. If the Congress credibly—now you have got to be credible, you can't play Mickey Mouse—but credibly cuts the spending path for the next 3 years by a large amount and does the things necessary credibly, enacts them, to pull the deficit down below $100 billion, I'll bet there isn't anybody on Wall Street who stands around doing what I would call second order calculations as to exactly where it is or what this will mean for the year 2010. Because anybody who bought a bond believing that the Congress' actions this year predicted what they were going to do 10 years from now ought to have his head examined anyway.

So I would say a dollar is somewhere between $0.95 and $1.05.

Senator BAUCUS. Thank you.

Along those same lines, as I indicated in my opening remarks, I am interested in a freeze, a total freeze, total across the board freeze in Federal spending, including all programs. I understand and agree with some of the modifications that Dr. Schultze suggested in some means tested programs that don't amount to very much in terms of total Federal spending.

I'm wondering if any of you as economists have any trouble with the total freeze on Federal spending, across the board freeze on spending.

Or let me state the same question differently. Tell me the degree to which you think that is either a good idea or a bad idea, strictly from the point of view as an economic proposition.

Senator PACKWOOD. Max, could I ask a question?

Senator BAUCUS. Sure.

Senator PACKWOOD. You mean a 1-year freeze only?

Senator BAUCUS. I mean a 1-year freeze only. That's right. As you pointed out, Mr. Chairman, that raises about the same amount as the President's proposed spending cuts in the first year.

One advantage a freeze has is that it permanently lowers the base because when we address future years, we are starting from a lower base in each of the following years the freeze is in place.

I understand that the question then becomes, well, what about 1987, fiscal 1988 and so forth. But my thought is that if we could freeze total Federal spending in 1 year of fiscal 1986, at least that does permanently lower the base. And, second, it gives us a 1 year period in which to try to get our act together and figure out what we are going to do about defense, entitlement, domestic spending and so forth.

We don't live in a perfect world, but it just seems to me that that is the place from which to begin.

Dr. FELDSTEIN. Senator, by a 1-year freeze, you mean that's all? Just a 1-year freeze and you let the future years——

Senator BAUCUS. I'm hoping Congress meets next year.

Dr. FELDSTEIN. But I think that would be a very big mistake. I think that's exactly the kind of piecemeal year at a time approach that I warned about, because then you would get lower spending in 1986, but you would have a much smaller impact on interest rates so you could easily push the economy into recession by a contractionary reduction in spending in 1986 without the favorable interest rate effects that depend upon expectations that this is a long-term, real reduction.

Senator BAUCUS. What would your reaction be to a 1-year across the board spending freeze but at the same time we enact that in year two it's an across the board spending freeze, plus 1 percent or something like that? Or hold the freeze for 2 years. I'm just curious if you could quantify that.

Dr. FELDSTEIN. The more you push long-term, the more you say this is just not a $40 billion slice in year 1 and a $42 billion slice in year 2. But actually is a major growing wedge that moves toward the kind of $100 billion remaining deficit by 1988 and lower after that. And the extent that you move toward that, then I don't, from a purely economic point of view, care whether you start by calling it a freeze or you design it some other way.

Senator BAUCUS. It's dangerous to modify it in these situations, but what if it's a 1 year spending freeze and on top of that we put in cuts we thought were appropriate for each of the next 2 years and enacted that in one package by summer?

Dr. FELDSTEIN. It depends on how many dollars a——

Senator BAUCUS. I'm assuming a very significant number of dollars in order to get at the problems we are getting at.

Dr. FELDSTEIN. Then whether the first year is designed in the form of a freeze or it's designed as a series of specific spending cuts is secondary. It is not the central issue. The issue is what the actual projected deficits are in each of the future several years.

Senator BAUCUS. Dr. Schultze, did you have any reaction to that?

Dr. SCHULTZE. Tell me precisely what you mean by a freeze. First, by a freeze do you mean you freeze cost of living allowances in entitlement programs that have such allowances; you don't just freeze spending?

Senator BAUCUS. Or freeze discretionary spending or——

Dr. SCHULTZE. For example, if you freeze all the entitlement programs in the sense of no cost of living allowances, if you freeze, that is, no increase at all in any of the discretionary civilian programs, my back of the envelope calculations tells me that's about $25 billion worth of cuts by the year 1988. It isn't as big as you think.

That is, if by freeze you simply mean I'm going to set a total that is no higher than last year for the total civilian budget of the Federal Government, that's quite a different kettle of fish. That means, for example, you have to do something explicit in the farm price support program. You can't just freeze it. You have got to change the law.

So I'm being longwinded, but the amount you will get out of a freeze—all COLA's frozen, no increase in discretionary programs—my guess would add to about $25 billion a year. You do the same thing to Defense appropriations, because you can't freeze spending, in real terms, you will get another $30 billion in 1988.

Senator BAUCUS. Well, the basic question I asked you is if we were to freeze along the lines you are suggesting, to what degree would the financial markets respond across the board.

Dr. SCHULTZE. If you did that and incorporated it in a long-term budget projection which showed your intention of holding it, I think it would be very good. I don't think it would be a problem.

Senator BAUCUS. Anybody disagree?

Dr. ROBERTS. As long as people don't think you are going to make the spending up in the following years.

Senator BAUCUS. Thank you very much.

Dr. ROBERTS. If they get that idea, it wouldn't work.

Senator BAUCUS. Thank you.

Senator DANFORTH. I'd like to reopen a point that Senator Moynihan made. Some would say that unless we do something to control the growth rate of entitlement programs there is no way to have the budget under sufficient control to produce the sort of economic results we would like. That entitlement programs now account for something like 45 or 50 percent of the budget; that their cost has been increasing very rapidly; and, therefore, there should

be some freeze or some adjustment of COLA's to try to control the growth rate of entitlements.

Other people might argue, as Senator Moynihan indicated in his question, that the entitlement programs are paying for themselves, that Social Security, we just passed a Social Security bill, and that, therefore, any effort to try to contain Social Security especially would be viewed as an effort not to address the Social Security question but as is often said to balance the budget on the backs of the elderly.

Very tough political argument to make, of course. I'd like your judgments as to whether it is possible or likely to come up with a credible approach to reducing the size of the deficit without including some adjustment of the growth rate of the entitlement programs. And if you care to venture it, some comment on the equity of doing that.

Dr. FELDSTEIN. I think it would be very, very difficult to get substantial reductions in the outyear deficits without dealing with the entitlement programs, middle income entitlement programs, including Social Security, unless you are prepared to have very large tax increases. I think the choice comes down to that.

I think after you have done as much as you possibly can to cut back on domestic spending programs other than the middle income entitlement programs and perhaps trimmed back on defense in a significant way, you are still going to be left with deficits that are far too large for a 2 percent of GNP target in 1988 and a balanced budget at the end of the decade.

I think that only leaves you the choice of having very large tax increases, tax increases on the order of $120 billion a year, or sharing that burden more generally by looking at the entitlement part of the budget.

I, frankly, don't see how Congress can cut the entitlement programs and the means tested part of the budget and not in the name of fairness also look at the nonmeans tested part of the budget.

Dr. SCHULTZE. Basically, I agree with Marty that since entitlements in effect are 10 percent of GNP and they are 40 percent of the budget in round numbers, you can't have a credible program that doesn't go after entitlements.

No. 2, however, I would also like to point out that it is no longer true, and hasn't been for a while now, that in some sense entitlements are out of hand, that the budget deficit can be explained by a continuing excessively rapid growth of entitlements. The problem is the level is high, but they are no longer growing in any out of hand way.

For example, in 1983 entitlements were 12.5 percent of GNP. In 1985, 10.6 percent. In 1989, 10.3 percent. As a share of GNP, it has been coming down. As a share of the budget, they have been coming down. They are high. They are such a large part of the budget you cannot go after in all good conscience the rest of the budget without going after them. But I wouldn't any longer blame the budget deficit fundamentally on out-of-control entitlements.

Dr. ROBERTS. Charlie, which years did you say they had come down? The recent years of high growth?

Dr. SCHULTZE. 1983—no, 1985 to 1989, slow growth.

Dr. ROBERTS. It has not happened yet. That's right.

I think that what the Social Security report shows, if I remember correctly, is that over the planning period, which is a long-term—something like 75 years—the real value of Social Security benefits are slated to triple, based on the assumptions of inflation and so on that are used in the report. So that shows a substantial growth in the real value of Social Security benefits over the planning period. It's a long-term planning period that is used.

That seems to be mainly due to the way the initial retirement benefits of each year's crop of retirees are determined. There is a formula that lets these benefits rise with labor productivity. So if you have got the real value of Social Security benefits growing with the growth of the economy, and you've got retirees growing faster than the work force, then you have got a situation where it looks to me like Social Security has to absorb a larger and larger share of GNP. So it would seem to me that you could fix that problem without really affecting current retirees. It would only affect people who are retiring in the future.

Senator DANFORTH. Dr. Greenspan.

Dr. GREENSPAN. I don't see any way in which a really significant reduction over the long-term of the unified budget deficit can be enacted without some significant curtailment of entitlement programs; specifically, with respect to the COLA's. I think we are making a mistake by ruling out COLA adjustments as a means of coming at this deficit problem.

We are swinging back and forth on the issue of whether or not Social Security, leaving out the Medicare segments, is appropriately funded. The payroll tax revenues allocated to the social insurance funds, excluding Medicare, in an accounting sense will keep the old age and survivors and disability funds in reasonably good shape. The problem, basically, is that Social Security is not an insurance program in the sense of full funding that a private insurance program is. The actuarial input coming from the taxes is not, in fact, equal to the present value of benefits paid out.

So in that sense, there is more going out than going in. From an equity point, it's difficult to make judgments of whether Social Security is a problem. What I would say is that there is no Social Security problem with respect to its allocated revenues. That issue was appropriately resolved with the congressional actions a year or so ago.

We are talking, however, about the unified budget deficit which includes all of these various programs. In that sense, the allocated revenues to Social Security basically are part of the total revenue input and the outlays are part of the total outlay. And if you look at the individual outlay items and the individual tax items, it is very difficult to avoid the conclusion that a really frontal assault on the deficit cannot eliminate from consideration the major entitlement programs. I know of no way to do that.

Senator PACKWOOD. David.

Senator PRYOR. Mr. Chairman, I'd like to ask a question of each of the participants today. And, once again, I think they are doing an excellent job. And this is a great way to start off the new year. For us to see some parameters. You men have been confidants and advisors to Presidents in the past and the present.

Would you give us, after these years of experience and what I consider to be a good understanding of Washington of how it works and doesn't work and what it responds to and doesn't respond to—could you share with us just a moment the approach on the spending side that you might advise a President or a Congress to consider these next several months as to the expenditures?

For example, is our approach wrong? Are we using the wrong approach right now in going through the reconciliation method and sort of taking each agency and line item by line item and how many cars they need and how many more computers they need? Is this going to meet the test or are we going to require some across the board program like a freeze as Senator Baucus has talked about and I have supported?

Frankly, I don't think the old system is going to get it. I may be wrong, and I don't know what system we ought to employ, but I think it's going to take—we used to say over on the House side—the frank bow meat ax approach, 5 percent off of you and so forth. I don't know that that's going to do it.

But I wonder if you gentlemen would share just a few moments as to what your approach would be and whether the approach we are using is outmoded and outdated and unworkable.

Dr. Greenspan.

Dr. GREENSPAN. I think the problems starts with the 1950's. Prior to then, there was a certain view in this country of what the appropriate functions of Government were. The areas which the Federal Government was responsible for did not have built into them an expansion which tended to eat into the real resources of the country.

More recently we have requested of the Federal Government to do more than I think our political system, the way we are structured, enables us to do. In a sense, we tend to create costless benefits. And it is very difficult to reverse this process.

Just going back to Social Security for a minute, there are many members of this committee who remember quite well how easy it was to get a 20-percent increase in Social Security benefits in 1972. That increase went through the Congress like a hot knife like butter. And if the former chairman, Mr. Long, were here, he could give you chapter and verse and some fascinating stories on that episode.

Senators Moynihan and Dole know we struggled hard and furiously in the Social Security Commission to recoup in dollar amounts a very small fraction of that.

There is a bias in the system. And unless that bias is redressed, we will have a continuous shift toward structural deficits. You may solve it with a Herculean effort in the next year or so, but that does not solve the fundamental institutional problem. That is the reason I testified many times that I thought the appropriate constitutional amendment was not to have a balanced budget amendment, but to require super majorities in both houses of the Congress on any money bill, on any authorization, appropriation or outlay on the grounds that if the bias were in the direction of increasing expenditures, if one could make it more difficult to pass expenditure legislation, one could presumably restore the balance that existed in the 1950's and earlier.

Dr. ROBERTS. Senator, as a former chief economist for the minority staff for the House Budget Committee I certainly agree with your doubts about the ability of the process as it works now to deal with the spending. And that's why I think that the approach you should take is that the Government's budget grows 2, 3 percentage points less than the growth of the economy.

If you do that and you stick to it, then you have got the problem under control.

Senator PRYOR. Thank you, Dr. Roberts.

Dr. SCHULTZE. I don't think it's fundamentally a process problem. The Congress does have a way—and it invented a pretty good way about 10 years ago to consider the total budget for the first time in it's history. And it has got a lot of flaws, but I think the Congress does a much better job and has a much better mechanism to look at the total budget, rather than just piecemeal.

You have several processes by which to enforce it. They are not perfect, and they don't work every year, but they are basically effected tools. The Congress is now considering and has for some years the future consequences of its actions. I can remember as a budget director 20 years ago it being very hard to get the President to concentrate on the next budget year, much less 5 years out.

But the Congress now does. I think all the mechanisms are there. We had small and very occasionally serious deficit problems until about 4 or 5 years ago, but they weren't overwhelming. We had some problem of an up-creep in the Federal share of GNP taken by the Federal Government, but it was pretty small, the smallest of any other country in the world. But it was there. It was a problem. It wasn't a big one, but it was there.

I think what we are suffering from now is the tremendous political difficulty of undoing a great big mistake we made 3 years ago. Thinking we could have a massive tax cut and very rapid increases in defense spending, and not suffer from budget problems. Well, you know, everybody bought it. The public liked it. The Congress liked it. Both sides of the aisle liked it. Some of the Democrats were trying to make the tax cut even larger so it's not a partisan matter. I think everybody made a big mistake. And it's as painful as the very dickens to try to undo that mistake because we are taking a lot of goodies back.

I think the process is there. But I'm not sure how serious the public is about the need to reduce the deficit. Actually of all the three elements that go into it—the Congress, the President, the public—I think the Congress is a lot more concerned about it than the other two. And it has the mechanism there to do something about it.

Dr. FELDSTEIN. I agree with Charlie that it's not a mechanism problem at this point. After all, what has happened in the last few years has shown the ability of the Congress and the administration to cut resources going to nondefense spending very, very sharply from 9½ percent of GNP in 1980 to a little more than 7 percent of GNP, and on a path that with no further legislative changes will take it down to 6½ percent of GNP. So I think you have shown you have the ability when you have the will to do it, to bring spending under control. What is required now is to continue to do that.

I think the key thing is to have a sense of a bottom line that you are aiming for early on. I think that the notion of 4 percent of GNP deficit in 1986, falling to 3 percent in 1987 and 2 percent in 1988, and then working back from that into the specific pieces really is what is needed at this point.

Senator PACKWOOD. Malcolm.

Senator WALLOP. Thank you, Mr. Chairman. I am, as always, fascinated by the collection of thoughts that come from the minds of economists, all of whom at this table I consider my friends, and many of whom I have had far too long an evening with in the course of these discussions.

But I want to know how it is or why it is or what it is that anybody thinks is the formula that exactly ties interest rates to deficits. I am mystified by the fact that with a $45 billion deficit the last year of the Carter administration we had 21½ percent interest rates. And I'm not sitting here as an advocate of deficits. I just want to know what the formula is. And I'm also mystified now why interest rates are coming down.

Alan? I mean I read Henry Kauffman's Solomon-like pronouncements from his Solomon-like firm, and they don't seem to have any more accuracy than anybody else's do. They have a lot more effect, but they don't have many more accuracies.

Dr. GREENSPAN. Solomon.

Senator WALLOP. Solomon and Salomon. I made the distinction. The Solomon-like pronouncements from the Salomon-like firm.

Dr. GREENSPAN. I think the problem is a concept—not a simple formula. There is a fairly easy way to demonstrate that very large deficits will lead to very high interest rates in extreme circumstances. We see it in developing countries all over. There is very little question that a major central government deficit financed by the central bank will generate a level of inflation which will embody itself in interest rates and hence the correlation will be extremely close.

Senator WALLOP. But would you agree with me, though, Alan, that the primary problem in developing countries is also state control of all the other means of creating capital?

Dr. GREENSPAN. Sure; that is part of the problem but it would exist even were that not the case. What the problem basically is is that central banks finance the government debt which finances the failure of receipts to equal expenditures. So at root is the process of the central bank, in our case the Federal Reserve, accommodating the debt.

If the central bank does not accommodate the debt, then the process is different. Demand exceeds the supply of capital and interest rates get driven up. The reason you will not find a simple correlation between deficits and interest rates—and, indeed, you can't—is that there are too many other complex forces acting, such as a very significant softening in private credit demands during a recession, a period when revenues fall for the central government and the deficit rises. So what appears on the surface at least in that period is a rise in deficit and a fall in interest rates.

The problem that you have is where it really matters, namely in the period ahead—it is very difficult to construct any meaningful scenario in which Federal budget deficits in the United States stay

at $200 billion and rise in which interest rates come down and stay down.

Senator WALLOP. You have no quarrel from me from that perspective, but you have a great quarrel from me as a panel for any conclusion that there is this direct correlation that can be cured by either a large tax increase or major efforts to cut without looking at the other things, which you just mentioned, the dynamics of a creative economy. And I just don't see—I don't know how we get that part of the argument into our decisionmaking here. We seem to be terrified of the idea of creating capital.

Paul.

Dr. ROBERTS. Well, Senator, I would tell you that none of the gentlemen here could give you the formula, the connecting deficits with interest rates. One of the things that the professional staff of the U.S. Treasury spent over 3 years studying at our request was to determine the effect of deficits on the prices of financial assets. And these were not politically appointed people. These were the professional staff at Treasury, every member of which was probably a Democrat because the Republicans never hire anybody when they take over the bureaucracy.

And they came up with a study that the Treasury published last year. It has a March date. It really didn't come out, I think, until May. And this includes a complete survey of every academic study on the subject. And you just can't find this simple relationship that is assumed and that has been assumed here today.

And this is why I think it's a mistake to base your efforts to control spending on some direct, immediate or clear impact on interest rates. If you look at the past 4 years, despite all the predictions about what the deficit was going to do to the interest rates and what the interest rates were going to do to investments and how there wouldn't be a recovery in 1983, you will see that none of these predictions came true. And despite rising deficits over this period and forecasts of rising deficits over this period, interest rates fell.

It's very interesting to look at what has happened to real interest rates over time. If you take, for example, DRI's——

Senator WALLOP. There is one other request I wanted to make. Revenues are not only a function of the percentage of taxes raised against things, but they are a percentage of the GNP, and the GNP can't grow beyond a certain point. Can it? Having tried its best, it still doesn't have enough capital in the system. I'm talking about the Federal Reserve to grow anymore. And that does something to interest rates as well as deficits, does it not?

Dr. FELDSTEIN. Yes. I agree with what you say. Certainly the GNP growth is constrained in part by the amount of capital we accumulate. But the Federal Reserve is not the supplier of capital for our economy. The suppliers of capital are the households and the businesses that do the saving, and that's where I think we have to be very careful about anything we do, you do, on the tax side.

Senator WALLOP. There is a relationship, is there not?

Dr. FELDSTEIN. Well, what the Federal Reserve does fundamentally over any long period of time is to affect the price level. It can give a short-term slowdown or short-term pickup in the rate of growth. It can create recessions and temporary booms. But it can't

determine the long-term real rate of growth of the economy. And the danger in trying to use the Federal Reserve to promote growth is that its a sure fire way of giving us more inflation.

Senator WALLOP. Well, I'm not suggesting that we do that. I'm simply suggesting though that an economy then that has done its darndest to grow and still has growth left in it and people seeking jobs, and still wish to do so can't, if you can't produce more revenue or more growth, if the money supply is so restricted that it is below the rate of efficiency that exists in the country——

Senator PACKWOOD. Dr. Roberts.

Dr. ROBERTS. Some of my former colleagues at the Treasury and I have recently completed a study that shows taxation has a greater impact on the cost of capital than does the interest rate. I would be pleased to submit it for the record.

[The study from Dr. Roberts follows:]

Supply-Side Economics and the Cost of Capital

Presented at the International Conference on
"Adjusting to Shocks - A North-South Perspective"

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Supply Side Economics and the Cost of Capital

by

Aldona E. Robbins, Gary A. Robbins, and Paul Craig Roberts 1/

I. Introduction

The paper calculates the relative impact of interest rates, taxes, and technology on the cost of capital. The results show that the cost of capital is highly inelastic with respect to changes in the interest rate. Taxation, however, substantially affects the cost of capital, raising it by 30 percent for the economy as a whole. Increases in the cost of capital due to tax changes raise the rate of return required from real productive assets, which translates into fewer viable investment opportunities.

The results of this paper dispute the policy prescription implied by the view that Federal deficits cause high interest rates, which in turn, crowd out investment. The view that higher taxes would reduce crowding out and raise the investment rate is inconsistent with our findings that taxation has significant adverse effects on the rate of capital formation.

II. A Supply Side Framework for Analyzing Production Costs

Since the time of the New Deal, American economic policy had been heavily influenced by Keynesian theory. Policymakers thought that by following "demand management" strategies of raising or lowering taxes and thereby increasing or decreasing the size of government, the economy could be kept on a stable growth path. Aggregate economic activity was believed to depend only upon average tax rates. Prices, other than the general price level, did not matter. In this framework only the level of disposable income for the economy as whole determines growth. Consequently, it was thought possible to redistribute income costlessly from one person or group to another by transferring income via the tax and welfare systems.

Problems, however, ensued. Neither the business cycle nor poverty was eliminated. It appeared that a trade-off existed between unemployment and inflation, the so-called Phillips curve. Unemployment, it seemed, could only be driven lower at the cost of higher inflation. Then a most puzzling event occurred. During the 1970s the economy experienced what came to be known as stagflation--the simultaneous occurrence of economic stagnation, high unemployment and high inflation.

These events readied the stage for the emergence of what became known as supply side economics. Although its name was

presumably to distinquish it from Keynesian demand side policies, it has led to some misconceptions. In fact supply side economics is really just the application of the microeconomic theory of consumption and production to the aggregate economy. Supply side theory posits that what is observed at the macroeconomic level is really the sum of all the individual microeconomic transactions in the economy.2/ Thus, the explanation of overall economic behavior actually lies in the myriad of markets which it encompasses.

According to the principles of microeconomics, markets are comprised of buyers with demand schedules and sellers with supply schedules. These schedules are merely lists of quantities of various goods or services that buyers are willing to purchase and sellers are willing to sell at various prices. For each good there will be one price at which the buyers' and sellers' quantities match, and the transaction is made.

The relevant point here, however, is that the buyers and sellers are responding to prices. Behind the derivation of each of these schedules is some very elegant theory which takes into account, among other things, the prices of all other goods and services. If any of these relative prices changes, the demand and supply schedules also change, unlike the textbook Keynesian framework where relative prices do not matter.

One of the basic premises of supply side economics is that government policy affects the relative prices of factors of production -- land, labor, and capital. During the 1970's, the effect of government policy was to raise the cost of capital and lower the return to labor by increasing the tax burden at all levels of government. The expansion of the government sector relative to the private sector thereby reduced the incentive to invest and to work.

III. Supply Side Economics and the Cost of Labor

Although the major focus of this paper is on capital, labor is a factor of production also affected by taxes. The impact of taxes on labor costs is easier to analyze because labor compensation generally occurs at the same time labor services are provided.

Workers generally measure their well-being in after-tax terms, namely gross wages less income and payroll taxes. Any increase in income or payroll taxes reduces the worker's after-tax wage and well-being unless the gross wage is raised by an appropriate amount. If this does not happen, an increase in tax rates causes the supply schedule of labor to shift up and to the left. The general concensus of econometric studies is that a 10 percent reduction in take-home pay reduces labor supply by about 4 percent.

Labor costs to the firm increase directly by any increase in employer payroll taxes and by any increase in wages that occurs as workers pass a portion of their income or payroll tax increases on to the firms in order to keep their after-tax wage from falling. As wage costs rise, labor becomes more expensive relative to capital, and firms will substitute capital for labor where possible, resulting in lower employment.

The disparity between gross before-tax labor compensation and after-tax wages of workers widened during the 1970's because of increases in income and payroll tax rates. The average marginal tax rate on U.S. wages rose from 21.2 percent in 1965 to 38.3 percent in 1981, almost a doubling. The increase due to income taxes alone was from 17.8 percent to 27.5 percent. Much of this rise was due to the silent tax increase known as "bracket creep". Because the U.S. Federal income tax system is progressive, additions to income are taxed at higher and higher rates. As workers' wages rise with inflation, they are pushed into higher tax brackets even though their real income has not changed. Consequently, the rapid inflation of the 1970's meant that firms had to increase gross wages at a rate faster than the rate of inflation simply to keep the worker in the same after-tax position.

Payroll taxes were growing even faster than income taxes. In the U.S. payroll taxes are used primarily to fund the social security system. The social security system required higher taxes for sufficient financing because real levels of cash benefits were increased, Medicare was added, and the pay-as-you-go system matured. In 1965 the combined employer-employee tax rate was 7.25 percent on the first $4,800 in wages. By 1981 this tax rate had risen to 13.3 percent on the first $29,700 in wages. Not only did the tax rate almost double, but the share of wages in the U.S. subject to the tax rose from 72 percent to 90 percent because of the sharp increase in the wage base. As in the case of "bracket creep", the firm had to increase continually the worker's gross wage in order to keep the worker's after-payroll tax wage the same.

The effect of rising average marginal income tax rates and payroll tax rates caused the cost of labor to increase without any compensating increases in productivity. As the cost of labor rises relative to capital, microeconomic theory predicts that the firm will substitute capital for labor where possible and/or reduce output. Capital, however, was subject to the same Federal income tax system. The remainder of the paper looks at what was happening to the cost of capital.

IV. Financial Instruments and the Investment Decision

Central to the topic of this conference is the impact of forces external to the economic decisionmaker, including government policy, on the investment process. It is impossible

to discuss the factors affecting economic progress without placing them into the context of their influence on the basic determinants of behavior. "Shocks" must be gauged in terms of their influence on the supply and demand for goods and services in order to gain any meaningful insight into their final effect.

Impacts on the supply of labor are the most easily seen since the provision of and payment for labor services are more or less coincident. For example, a shock which affects the labor contract can be judged in terms of the likely effect on the labor supply schedule and can be quickly analyzed through the easily observable impacts on wages and employment.

The analysis of the impact of shocks on the supply of capital services is much less straightforward because its pattern of compensation spans more than one period. The analyst must develop a method to translate a multiperiod investment compensation pattern into current period equivalents. This falls under the general rubric of the service price. The analysis will now proceed by examining the financial investment decision in detail. A set of principles will be developed that will ultimately be applied to the purchase of a real capital asset.

A. Consol with perfect foresight

Zero inflation, no tax

First the textbook example of a consol, i.e., an asset which yields an infinitely-lived, constant stream of earnings is examined. At the margin the net payment per period from the consol divided by its purchase price equals the discount rate for the individual as well as for the market. Knowing two of the three elements of the transaction uniquely determines the third. For example, in order to induce an investor with a discount rate of 4 percent to purchase a consol of $1,000, the net payment, or debt service, per period must be $40. The formula for the debt service in the case of a simple consol is written as

(1) Consol Debt Service = $ 1 * r

where r is the rate of time preference or discount rate.

The discount rate is the rate of time preference for the individual and for the market. To avoid unnecessary complications, the remaining analysis assumes that the discount rate remains constant through time. Also the formulas will employ continuous compounding and the purchase price of the assets portrayed will be one dollar.

Inflation, no tax

The presence of inflation means that the value of the goods that can be purchased with the proceeds from the consol changes from period to period. Future net payments must, therefore, be

adjusted for changes in purchasing power. If inflation is expected to run at 5 percent (forever), the value of all future payments and therefore the principal from any subsequent sale is reduced by 5 percent each year, and the debt service payment in the previous example would have to increase from $40 per period to $90 to keep the investor no worse off after inflation. Thus, the relation between the debt service payment and the purchase price is modified to be the discount rate plus the inflation rate. This is normally termed an "inflation premium". The debt service in this case is written as

(2) Consol with Inflation Debt Service = $ 1 * (r + z)

where z is the expected inflation rate.

Inflation and a tax

The presence of a tax directly reduces the net payment received by the investor, requiring a higher pre-tax payment to keep the investor as well off as before. Assuming a 50 percent tax rate, half of the proceeds of each payment goes to the taxing authority. From our above example the payment amount would have to double from $90 to $180 per period. The debt service formula is modified to be

(3) Consol with Inflation & Tax Debt Service =
$ 1 * (r + z)/(1 - t)

where t is the expected marginal tax rate.

Now the mathematical relation becomes the discount rate plus the inflation rate all divided by one minus the tax rate to "gross up" the after-tax amounts to necessary pre-tax amounts. The term "gross-up" is used in the remainder of the paper to indicate this translation. Note that the tax is levied on the inflation premium as well as the pure interest element of the consol. This phenomenon, referred to as the Fisher effect, explains an important interaction between taxes, inflation, and the interest rate. As either taxes or inflation increase, the nominal interest rate must increase at a faster pace that the simple sum of the previous two rates.

B. Purchase of a bond with perfect foresight

The previous analysis can be easily extended from an infinite payment stream to one with a fixed time horizon and repayment of principal. In this case, the previous examples can be thought of as the equivalent of two simple transactions: (a) purchase of the consol and (b) subsequent sale at a price agreed to at the time of purchase. Under conditions of constant inflation and rate of time preference, the geometry of the bond analysis and the consol are identical. Varying either the inflation rate or discount rate will complicate the problem but not materially change the conclusions. The resulting formula for a bond's debt service is

(4) Bond Debt Service = $ 1 * (1 - EXP[-(r + z) * T])
*((r + z)/(1 - EXP[-(r + z) * T])/(1 - t)

= $ 1 * (r + z)/(1 - t).

where T is the maturity date.

The payment amount necessary to attract the investor in our example is the original purchase price of the instrument less the inflation-adjusted, discounted value of the future return of principal. The term, net-of-tax private present costs, is used to denote the net present value of costs and repayments that are not directly related to the income stream of the asset -- in this case, the original purchase price less the present value of the return of principal. This allows the analysis to concentrate separately on the net acquisition/principal repayment and the periodic income, the two major aspects of the transaction.

This valuation of the net-of-tax private present cost of the bond must be recovered over the term of the bond along with the net interest income required by the investor. The present value of the payment stream will be used to characterize both the level and pattern of the periodic income stream. The general formula for the debt service of an investment is the net-of-tax private present cost of the investment, (1 - EXP[-(r + z) * T]), grossed-up for taxes, and divided by the present value of the payment stream, (1 - EXP[-(r + z) * T])/(r + z). This can be seen to reduce to our previous example, and the debt service will be exactly as before, or $180 per period.

Empirical data support the behavior of nominal interest rates, inflation, and taxes just posited. The top graph in Plate 1 plots the nominal U.S. 20-year Treasury bond rate against the rate of increase of the private GNP deflator over the period 1954-83. As expected, nominal interest rates and inflation move in somewhat the same direction. Some analysts take the difference of these two series and call it the <u>real interest rate</u>. Two noteworthy observations about this graph should be made: 1) there are several periods when the real interest rate is negative, and 2) taxes have been ignored.

The bottom graph in Plate 1 adjusts the nominal interest rate for taxes using the weighted average marginal tax rate on interest income at the Federal, state, and local levels prevailing in the United States at each period and plots it against inflation. The difference between these two series is referred to as the real after-tax interest rate. After-tax nominal interest rates follow the rate of inflation more closely than the before-tax rates, and there are even longer periods of negative returns to ownership of U.S. Treasury bonds! In order to explain these periods we must look to other causes of this divergence.

C. Purchase of a bond with risk

Up to this point in our analysis we have assumed that the investor knows all current and future prices. However, this is not the way the real world operates. Rather, the investor and the market must make guesses about future prices and taxes. These guesses are incorporated into our analysis as "expected" inflation rates and "expected" tax rates.

Expectations are generally characterized by a mean and by a standard deviation, or a measure of the likely dispersion of anticipated future prices. In the case of perfect knowledge, all the investor needs to know is the average inflation and tax rates because their standard deviations are zero. In our current circumstance the investor must include a risk premium to cover the costs of making a wrong guess. This risk premium is directly related to the perceived standard deviation of future prices. Because a guess involves judgment on the part of an investor or the market, there is no guarantee that the guess will be right. Thus the presence of risk and of future inflation expectations differing from those currently prevailing can explain periods -- even long ones -- of apparent negative returns.

The relation has to be elaborated one step further to include a term reflecting the risk of misguessing inflation, i.e., the risk premium. This taxable risk premium must be added to the discount rate and inflation term. Assume that the risk premium is 2 percentage points. The value of the translation factor increases from 18 percent to 22 percent after tax. The debt service stream increases accordingly from $180 to $220. Note that the Fisher effect directly extends to risk premia as well as to inflation rates, and the debt service formula becomes

(5) Bond with Risk Debt Service = $ 1 * (r + z + risk)/(1 - t)

where risk is the expected loss or risk.

D. Choice between bonds with differing risk

The assumption that investors will always choose those investments they believe will yield the greatest net return extends the analytic framework to a wider application. Since the discount rate and price forecast must be identical for each investment alternative considered, the investor will always choose the one which yields the higher net return. At equilibrium, the after-tax net of risk rates of return must be equal between every pairwise set and therefore for all investments. If the returns are not equal, an arbitrage situation will exist which will be exploited by "selling" the asset with the lower return and "buying" the the one with the higher return until the two expected returns are identical. Thus the market equilibrium condition requires that each asset compete with every other.

Arbitrage in a rational market means that the relevant market for the determination of prices or rates of return for financial instruments must include the entire set of instruments available or known to the population of investors. The degree of interdependence necessary to assure this result is surprisingly small, merely that at least one investor know that the opportunity exists. This is because one investor can buy and sell enough of the two disparate issues to drive their prices into line. Those who argue a persistent divergence must also argue that they themselves are irrational since they forego the opportunity to make certain and instant profits from the knowledge they profess to have. It seems more realistic to proceed on the premise that the market will yield equal expected risk-adjusted after-tax returns for all the pairwise choices available. New issues must compete with other new issues as well as all pre-existing issues. The relevant market for rate determination is the entire portfolio of choices available to investors, and the market supply, therefore, is the stock of assets not simply the flow of new issues.

E. International choice; the exchange rate

The extension of this analysis to include investment across borders requires only that the price expectation process be elaborated to include the movements of more than one currency. As previously found, the investor must make some judgement about the value of future financial flows in order to chose between alternative investments. The denomination of the terms of the instrument may dictate that two translations be made before the transaction can be evaluated in terms of real goods or services. The exchange rate is a simple short-hand characterization of this dual forecasting problem. As in the previous example, the investor must convert all future payments into his current unit of account. This requires both forecast of the likely future prices in his domestic currency and the likely exchange rate between his currency and that in which the instrument is paid. As before, these forecasts must be made in the face of uncertainty and therefore must include and provide explicit accounting for the likelihood of loss through the inclusion of risk premia,

$$\text{(6) Foreign Bond Debt Service} = \$\,1 * (r + z + \text{risk} + \text{diff}) / (1 - t)$$

where diff is the expected differential inflation rates.

Because the typical investor does not possess the necessary information to make the exchange rate forecast, this is normally left to specialists who do little else. This fact does not diminish the degree of competition between instruments of different countries since competition only requires one person to arbitrage the market to a point where all issues compete with one another. Thus, in the final analysis, U.S. government issues compete with those of the Sony Corporation, etc. Although this

competition requirement could be relaxed somewhat to allow small deviations to exist, it would add nothing to the analysis of the tendencies of the market except needless complication of the mathematics.

V. Real Assets and the Investment Decision: Derivation of a Capital Service Price

The analysis necessarily becomes more complicated when one moves to a discussion of investment in real assets. This is due to the problem of characterizing the productive life in the value of a real asset. Complications also occur because of the more intricate tax treatment of capital assets and their returns. These complexities include accounting for property taxes, indirect business taxes, multiple levels of direct taxation (e.g. at both the corporate and personal levels), investment credits, and capital cost recovery systems.

For a given real asset, one can calculate an implied rental rate, analogous to the coupon rate, which equates the rate of compensation that would accrue to the owner if the asset's productive services were to be sold in a competitive rental market. These rentals would have to be at levels sufficient to cover both the anticipated taxes and expected decline in the asset's productive capability while maintaining a "normal" (risk-inclusive) rate of return. This rate of return, net of risk, is the same return required in the prior examples. For a given tax regime and a known pattern of productive efficiency, these rentals may be summarized by a capital service price. This service price represents the minimum current marginal value product that must be earned by an additional dollar's investment in the asset in order for that extra investment to be undertaken.

The usual derivation of the service price assumes that investors maximize their prospective wealth position. Investment in each alternative asset continues until further increments no longer yield an increase to expected wealth. This method yields an expression for the service price that relates the necessary before-tax return to the required after-tax return just as in the prior financial examples. As mentioned, the service price must cover expected loss in the asset's value and yield the same net return as alternative investments.

Before describing the derivation of the service price, an important point regarding the use of debt financing must be addressed. Recall that the investor must measure the cost of the marginal dollar's worth of investment. That dollar may be obtained either through borrowing or through equity financing. However, there can be only one single cost of capital at equilibrium given the arbitrage requirement. If there were more than one, the investor would always choose the least cost method of financing. But because both means of financing are observed, the cost of debt and equity financing must be equal at the

margin. Thus, the service price calculations described below are equally valid for a leveraged as well as an equity-financed investment.3/

A. Constantly decaying asset with perfect foresight

As in the case of the financial assets, a simple investment can be used to introduce a framework for further analysis. An asset with a geometrically declining pattern of output is analogous to the simple consol. In this case the investor must receive a service flow sufficient to cover his rate of time preference plus the decline in value of the asset each period. The formula for the service price in this simple case is

(7) Capital Service Price = $1 * (r + d)

where d is the percentage decline in the value of the asset in terms of future output.

Inflation and a Sales Tax

Since the service price is in terms of units of real output, there is no change needed in the formula to incorporate inflation. The presence of a sales tax, however, reduces the net payment received by the investor. The service price formula in (7) must be grossed-up and becomes

(8) Capital Service Price = $1 * (r + d)/(1 - ts)

where ts is the sales tax rate.

Risk can be incorporated at this point by defining r so that it contains both the rate of time preference and a risk premium.

Inflation and an Income Tax

An income tax introduces yet another term, tax depreciation, to the analysis. Unlike a financial asset the principal of the investment in a real asset is not returned, and an adjustment in the income flow must be made to attempt to incorporate the change in net worth for income tax purposes. The U.S. income tax laws measure income for tax purposes by subtracting an arbitrary "depreciation deduction" from the gross returns to capital which reduces the net-of-tax private present cost of the investment. Tax depreciation, in contrast with the decline in the real productivity of the asset, is a financial asset in that it is a financial allowance against taxes over some specified time. Thus, the depreciation term must be valued with an inflation term and within the context of the tax savings it yields the investor. The capital service price of straight-line depreciation becomes

(9a) Capital Service Price =
$$\$1 * (1 - t*(1 - EXP[-(r + z) * T])/(r + z)] * [(r+d)/(1-t)]$$

where T is the arbitrary tax life and t is the income tax rate.

Using names and symbols to simplify, equation (9a) may be rewritten as

(9b) Capital Service Price = $\$1 * (1 - D)*[SP/(1 - t)]$

where D is the present value of tax savings due to depreciation deductions and SP is the service price of the asset disregarding taxes from equation (7).

It must be remembered that each of these two short-hand terms represent more complex expressions containing r, the rate of time preference plus risk, and z, the expected inflation rate. Finally, each of the prior equations could be solved for r in terms of the existing service price to yield the real after-tax rate of return to capital which is nothing more than the rate of time preference plus the risk of owning a real capital investment. Thus the analysis which follows will allow the description of technological factors and tax depreciation schedules to become extremely complex without obscuring the basic relationship between the service price and the real rate of return to capital.

Inflation, Income and Indirect Taxes

The complete service price calculation used in this study requires several steps to incorporate all the major features of taxation. In order to simplify the analysis and emphasize the relative importance of the various taxes applied to the returns to real capital, the influence of income taxes is considered first in isolation, and then indirect, namely sales and property taxes, are added.

The return on capital subject only to income tax can be expressed by subtracting the investment tax credit and the tax value of depreciation terms described above from the gross costs of the asset,4/

(10a) Capital Service Price = $\$1*(1 - itc - D) * SP / (1 - t)$

where itc is the investment tax credit rate, D is the present value of tax depreciation, SP is the service price of the asset disregarding taxes, and t is the income tax rate.

In the U,S., indirect taxes, i.e., property and sales, also add to the "tax wedge" between pre-tax market returns and after-tax returns to investors in real assets. It is important to realize that the returns to capital must be sufficient to pay

sales or VAT taxes and property taxes. To account for these costs, the rate of property taxation must be added to the service price expression described above. Then, the entire expression must be grossed-up to reflect taxes on the sales or production of final output. The entire formula for the service price is

(10b) Capital Service Price =

$$\$\ 1 * [tp + (1 - itc - td) * SP/(1 - t)] / (1 - ts)$$

where tp is property tax rate and ts is the sales tax rate.

Because property taxes at any point in time are levied on the after-tax discounted present value of the remaining productive stream, it is as if the taxing authority adds a fixed percentage to the private cost of acquiring the asset. The sales tax takes a fixed percentage from the flow which services the investment. Thus, property taxes add directly to the cost of acquiring the asset, and the sales tax requires an additional gross-up factor.

VI. The Impact of Taxes and Interest Rates on the Service Price

Estimates of the service price are now presented for U.S. corporate nonresidential depreciable investment under the current tax regime using formula (10b) derived above. (A more detail description is contained in the technical appendix.) Data for 37 types of equipment and structures in 73 industries have been weighted using 1980 investment levels -- the latest available official data -- to construct average service prices for the economy. The real after-tax rate of return prevailing in 1983 is assumed equal across all industries. The nominal after-tax interest rate has been constructed to be consistent with the current 10 percent nominal long term interest rate.

The estimates of the productive service streams (economic depreciation) were constructed using U.S. Department of Commerce methodology and U.S. Treasury studies which were used to estimate the 1962 Class Life System. The tax rates are estimates of the weighted average marginal tax rates in 1983 again using Treasury and Commerce information.

The service price of capital is influenced by technological factors, such as how quickly the capital wears out or becomes obsolete, by the tax structure, and by interest rates. The table below reports estimates of the service price of capital under various tax assumptions. The service price levels in percent represent the current marginal value product of capital per unit of output necessary to warrant undertaking the investment. The technology estimates were constructed by literally setting all tax parameters to zero. In a "no-tax" world current technological factors are such that the marginal value product of capital per unit of output would be 18.99 percent for equipment, 6.04 percent for structures, and 14.61 percent overall.

SERVICE PRICES FOR U.S. CORPORATE NONRESIDENTIAL
DEPRECIABLE INVESTMENT UNDER CURRENT LAW (1984 ACRS)

	EQUIPMENT	STRUCTURES	TOTAL
Service Price per Unit of Output			
TECHNOLOGY ONLY	18.99%	6.04%	14.61%
PROPERTY TAX ONLY	22.21%	9.26%	17.83%
SALES TAX ONLY	20.03%	6.37%	15.41%
PROPERTY & SALES TAXES ONLY	23.42%	9.77%	18.80%
INCOME TAXES ONLY	20.64%	8.60%	16.57%
ALL TAXES	25.16%	12.46%	20.86%
Relative Contribution of Technological and Tax Factors			
TECHNOLOGY ONLY	75.49%	48.49%	70.03%
PROPERTY TAX ONLY	12.80%	25.83%	15.43%
SALES TAX ONLY	4.11%	2.64%	3.81%
PROPERTY & SALES TAXES ONLY	17.60%	29.88%	20.08%
INCOME TAXES ONLY	6.55%	20.52%	9.38%
EFFECTIVE TAX RATES	24.51%	51.51%	29.97%

The tax entries were similarly constructed by computing the service price with all other tax parameters to zero. The results for property taxes, sales taxes, indirect business taxes (combined property and sales taxes), and direct business taxes (Federal, state, and local income taxes) are shown separately. Taking all taxes into account, the service price for equipment increases from 19 percent to 25.16 percent, the service price for structures from 6.04 percent to 12.46 percent, and the service price for economy-wide capital from 14.6 percent to 20.86 percent.

The second set of entries in the table was constructed to illustrate the relative contribution of technological factors and taxes to the total service price. As can be seen, technological factors, such as the productive life of a piece of capital, comprise 70 percent of the economy-wide service price -- the lion's share of the cost of employing capital. Because of non-linearities, the entries are not additive.

Property taxes are the second largest contributor, accounting for 15.4 percent of the economy-wide service price. This result may seem surprising because property taxes are generally ignored in the analysis of capital costs. As explained earlier, their importance may be explained by the fact that the tax is applied to the "assessed value" of the capital asset whereas it is paid from the flow of revenue generated by the asset. Federal, state, and local income taxes follow next,

contributing 9.4 percent of the service price, and sales taxes account for the smallest share, less than 4 percent.

The "EFFECTIVE TAX RATES" entry is the implied tax wedge on capital income. It is calculated by applying equation (10b) cited previously. That is, the tax is equal to one minus the ratio of the "TECHNOLOGY ONLY" line to the "ALL TAXES" line. According to these estimates the current Federal, state, and local tax regimes increase the service price of equipment by 25 percent, of structures by 52 percent, and of economy-wide capital by 30 percent.

As for the impact of interest rates, the estimate of the elasticity of the service price with respect to the real after-tax interest rate is shown below. It was constructed by increasing the nominal interest rate from 10.0 to 11.5 percent while holding the real rate of return to capital and expected inflation constant.

ELASTICITY OF THE SERVICE PRICE OF CAPITAL
WITH RESPECT TO THE REAL AFTER-TAX INTEREST RATE

	EQUIPMENT	STRUCTURES	TOTAL
ELASTICITY	0.0453	0.3701	0.1110

As can be seen, small changes in the real interest rate have very little effect on the service price of capital and therefore on total investment. A ten percent increase in the real after-tax interest rate increases the service price of equipment by only 0.4 percent and the service price of structures by 3.7 percent. The effect of a ten percent increase in the real after-tax interest rate on the service price of capital economy-wide is only 1.1 percent. Thus, the commonly held notion that movements in the real interest rate greatly affect the cost of investment, is not supported by either the geometry of investment decisions or the data used in their calculation.

In summary, the service price of capital depends on technological factors, interest rates, and taxes. This section has presented calculations which measure the impact of the various factors on the service price. The results indicate that, contrary to popular wisdom, changes in the real after-tax interest rate have little effect on the service price. The primary determinant of the service price is technology, a non-policy variable.

The other major determinant is the tax structure. Taxes, until recently, have been virtually overlooked in investment analysis. Some attention is now being turned to Federal income taxes, in particular the treatment of depreciation. The results presented here, however, point to property taxes as the biggest contributor to the service price among the tax terms and second

only to technology overall. These findings suggest that future analyses of capital costs need to examine the overall tax structure.

The preceding analysis of the real interest rate's influence on the real after-tax rate of return to capital is a partial one. A complete general equilibrium framework, not attempted here, would yield an even smaller impact of interest rates on the service price. First, the service price must equal the marginal value product of capital which cannot change very rapidly since it is based on the entire stock of capital, not merely new investment. This stock changes very slowly, replacing the depreciable portion every 10 years on average. Short-term adjustments to fluctuations in the real interest rate would have to be translated into adjustments in the short-run demand conditions for the factors of production.

The appropriate demand schedule for the stock of capital (or investment) is its marginal value product schedule which relates the value of additions to output from increases in the use of capital. The elasticity of the marginal value product with respect to capital is equal to the factor's income share minus one. Using the standard estimate range of 3/10 to 1/3 for the income share of capital in the U.S., estimates of the elasticity of the marginal value product schedule are in the -7/10 to -2/3 range, which means that stock changes would result in smaller (by about 1/3) changes in magnitude in the service price.

Further, in the short run, an increase in the real rate of interest translates into a reduction in the real after-tax return to capital because the gross return, or service price, does not vary. The reduction in the net return to capital results in some substitution of labor for capital which partially offsets the static change. This substitution alters the capital/labor mix at a lower level of capital. Thus, the final change in the service price as a result of a change in the interest rate would be smaller than those reported in the table. In the long-run, the amount of investment would adjust to bring the return to real assets to its equilibrium value.

Finally, the impact of real after-tax interest rates on the service price of capital enters only through the income tax system. Higher interest rates reduce the present tax value of depreciation deductions since they are financial in nature. For the inframarginal, leveraged investments , the interest rate enters through the depreciation deductions and through the value of interest paid deductions. An increase in interest rates results in an increase in the service price of capital in the long-term but only through its impact on tax write-offs.

VII. The "Real Interest Rate"

The level of real interest rates in the United States has been the subject of much attention lately. Plate 2 contains a graph of the real after-tax interest rate and the real after-tax rate of return to capital. The latter measure was calculated rewriting equation (10b) such that the service price of each type of capital weighted by the appropriate stocks yields the observed gross return to capital in the U.S. This process assures that the rate of return to each asset is equal and that the differential tax treatment of each is taken into account. As can be seen, the rate of return to real capital has been much more stable than the interest rate over the 30 year period shown. The deviations largely occur during adjustment to new business conditions, such as changes in taxation.

In dramatic contrast, the real return to financial assets has experienced enormous swings during the period, the largest being the current positive swing. A similarly large negative swing occured during the 1970's. What causes these swings? In the context of the framework developed above, they must be interpreted as swings in investors' expectations about future changes in inflation or taxes or in their evaluation of the riskiness of those forecasts. The return to real capital does not share this inflation sensitivity since its return is in real products which increase in nominal value with inflation. Thus, the difference in the nature of the risks facing financial versus real investments could explain the difference in the patterns of their real after-tax returns.

Others have argued that swings in the interest rate really represent changes in the "demand for credit". Although the precise definition of the actual market these analysts allude to is not clear, their general argument is that high government credit demands cause high real interest rates. Plate 2 clearly demonstrates that this analytical position is not borne out by empirical data. The third largest U.S. Federal government deficit in history ($69 billion in 1975) occurred during the last negative swing. The government credit demand theory has not been supported by any econometric study of the empirical evidence to date.5/ This is not to suggest that there is no relation between credit demands and interest rates but rather that large government credit demands cannot explain the large swings in real after-tax interest rates.

Plate 2 shows a continued decline in the real after-tax rate of return to capital through 1982 despite the "massive" 1981 tax cuts. This apparent anomaly may be explained by the fact that the property tax rate grew by 8 percent over 1981-82. Given the major influence of this tax on the service price of capital, as previously shown, the real after-tax rate of return continued to fall until the personal tax cuts were phased in sufficiently to offset the increase in property taxes.

Investment implications

Whatever the causes of the current high real financial returns, many in the U.S. and the rest of the world are concerned that high real interest rates portend a downturn in economic activity. The high borrowing costs will choke investment incentives and end the current recovery. This argument is supposedly augmented by the fact that the Federal government is also making large demands on credit markets which will further "crowd out" investment. The graphs on Plate 3 present data to test this proposition.

The top graph plots an investment rate defined as the deviations from the 30 year mean of the ratio of business fixed investment to total gross national product against the real after-tax return to financial assets. Under the above hypothesis, the after-tax borrowing cost to an investor in real assets should closely mirror the similar return to a lender. Investment, therefore, should be highly correlated with the after-tax return to financial assets. This does not, however, seem to be the case. During the 1970's and 1980's there appears to be little relationship between the two series. In fact, the U.S. is currently enjoying a capital boom in spite of the historically high real rates. This graph tends to confirm the result reported earlier in the paper that the impact of borrowing costs is a minor one in the translation of the purchase price of capital goods into the required service price.

The bottom graph, which plots the rate of return on real assets against the investment rate clearly indicates that the real rate of return to capital as derived from the service price is a much better predictor of investment behavior than real financial interest rates. Large swings in the real after-tax interest rate do not coincide with immediate adjustments in investment. Rather, the swings occur at turning points in the level of investment activity. The direction of influence seems more likely one of the profitability of alternative real investments affecting the required financial return rather than financing costs affecting investment. This corresponds closely with the classical notion that the interest rate is made up of the riskless return to real capital plus a premium for risk plus an inflation premium.

The proposition that income could be redistributed at little cost to aggregate economic activity was based on early empirical research that indicated little or no responsiveness of investment to the rate of return. Since this return on investment was mistakenly assumed to be measured by the real interest rate, the top graph on Plate 4 indicates how one could reach that conclusion. As can be seen there is little correlation between the real interest rate and investment, and a statistical regression analysis would show extremely small or insignificant coefficients between the two. The real interest rate series is the same 20 year Treasury bond rate less current inflation but

before taxes. The investment rate is the ratio of business fixed investment to gross national product. Both series are again presented as deviations from their 30 year means, but the series have been scaled to their largest positive value to simulate the mathematics of a linear regression. The omission of taxes greatly misstates the return to investment, and the best characterization of the relationship of the two series would be one of a random walk.

In the bottom graph, the "price" term is the real after-tax return to capital as defined previously which corrects the mismeasurement problem in the top graph. The investment rate has been calculated as the ratio of investment to private output available to be allocated by the private sector. The private output measure is GNP less the goods and services preempted by the government and net exports. The same scaling used in the top chart is applied here. The "fit" is quite striking and certainly does not support the conclusion that the two series are unrelated.

These two charts support the previous conclusion that the real interest rate has a relatively small influence on both the service price of capital and the rate of return to capital. Graph 1 should be no surprise, and graph 2 is simply as classical theory would predict. The lesson to be learned is that the effect of taxes must be taken into account when relative prices are called for by the theory. A similar mistake is made in current econometric practice when an assumption is made that the interest rate is the appropriate discount rate for calculating the service price. This brings us back to the top graph on plate 3 which is clearly an inferior relationship. Finally, the level of government preemption must be subtracted from the "income term" in the relation to correctly gauge the budget constraint in the allocation of products between consumption and investment.

VIII. Implications for International Flows

Since this conference is concerned with the international implications of economic policy, let us consider the likely impact of recent U.S. developments. The first, of course, is the substantial U.S. trade deficit which some in the U.S. have viewed with great alarm. The deficit is viewed as arising solely from a severe export slump. The data, however, show that exports have enjoyed a recovery comparable to other segments of the economy, growing by 5.5 percent in real terms since the beginning of the recovery in late 1982. Import increases have been much greater than those during a typical recovery and "explain" the current deficit. Although exports typically lag during a recovery, they have been a major contributor to this current expansion, trailing only capital spending, which has experienced a 15 percent expansion. Except for the extraordinary import expansion, the trade sector seems to be behaving in a manner consistent with recent U.S. recoveries.

The second widely held proposition is that foreign investors are financing most of the additional U.S. federal deficit because of high U.S. real interest rates. Further, this is "hot money" which will flee the U.S. as soon as the financial climate changes. Again the data do not support this position. The capital flows into and out of the U.S. are reported in the table below.

Capital Flows, 1982 to 1984
($ billions)

Year	U.S. Outflow	U.S. Inflow
1982	$ 119	$ 95
1983	49	82
1984*	57	103

Source: U.S. Treasury

*First two quarters annualized

These data show a marked decrease in outflow, not a substantial increase in inflow. The inflow levels appear to be in line with normal growth. A more plausible explanation of the change in net flows is the increased attractiveness of U.S. real investment due to the 1981 tax changes which reduced the prices of U.S. factors of production, both capital and labor, and raised the real after-tax return to capital in the U.S.

IX. Conclusions

Where does this leave us in the discussion of the service price of capital and what this type of analysis can tell us about likely future U.S. policy adjustments? The clear message from the graphs is that the high "real interest rate" is a misleading indicator of current economic incentives to make real investments. Rather, it is the rate of return on real assets, as determined by the service price of capital, which determines the level of business investment. A lower required service price leads to greater investment and higher economic growth. Indeed recent reductions in the service price of capital were made possible in part by the Economic Recovery Tax Act of 1981 (ERTA) which lowered marginal tax rates and instituted an accelerated cost recovery system of depreciation. The full impact of ERTA tax cuts have only become fully effective during the last year.

The analysis suggests that a tax increase for the purpose of reducing the deficit in order to lower interest rates and promote investment is completely misdirected. The tax increase would increase the cost of labor and capital, thereby reducing the growth rates of investment and output. Any decline in interest rates would reflect the fall in investment and GNP growth. Slower growth could prompt greater inflation, or fears of inflation. and result in higher rates of interest.

During the recent election campaign President Reagan repeated his commitment to long-term economic growth. This represents a fundamental shift in the approach of the Federal government to the economy. Over the last four decades the U.S. had been primarily influenced by a welfare state philosophy. Support for this philosophy was made possible through use of an income-expenditure macroeconomic framework, which held that the government could costlessly redistribute income among individuals via the tax and transfer system. Under this approach transfer payments to individuals grew from 14.7 percent of government expenditures in 1954 to 31.6 percent in 1983, or an increase of 216 percent. The taxes needed to support this increase grew as well.

The 1980's seem to be ushering in a new approach to government and the economy. The ideal of a welfare state is being challenged by the concept of an opportunity society. This approach recognizes that the transfer of income is not costless, particularly when done through the tax and welfare system. Rather than redistribute existing wealth, the emphasis is on creating new wealth through growth. To some extent this means starting fresh from where we are today while making sure that in the future everyone has the same opportunity to make the best use of his or her individual talents.

Continuing growth is predicated on increasing productivity, which, in turn requires increasing the capital-to-labor ratio. If the U.S. is not successful in its attempts to achieve long term growth through increased investment and higher productivity, the current adjustments underway in the older so-called "smokestack" industries to restore their competitiveness in world markets will be undercut. Protectionist pressures in the U.S. would increase, and the Western Alliance would unravel as the U.S. closed its markets to its allies. Such prospects are so unattractive that we believe a supply side policy will prevail.

Footnotes:

1/ U.S. Treasury Department; U.S. Treasury Department; and Center for Strategic and International Studies, Georgetown University.

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The material contained in this paper does not represent an official position of the U.S. Treasury, and the authors accept sole responsibility for any errors.

2/ See Keleher, R. E. and Orzechowski, W. P., "Supply-Side Effects of Fiscal Policy: Some Historical Perspectives," Federal Reserve Bank of Atlanta Working Paper Series, August 1980 for a history of supply side thought.

3/ A change in the price of debt will alter the equilibrium debt/equity position of the firm, changing its degree of risk. This will be reflected in the real rate of discount which is being held constant for this analysis. This is not an unreasonable assumption in light of the economy-wide accounting system also being used.

4/ An investment tax credit granted at the time the investment is put into service has an immediate direct tax effect, e.g., a ten percent credit will offset tax liability up to ten percent of the asset's purchase price. (Excess credits are normally carried forward until exhausted.)

5/ See The Office of the Assistant Secretary for Economic Policy, U.S. Treasury Department, The Effects of Deficits on Prices of Financial Assets: Theory and Evidence, 1984.

Technical Appendix

Description of Service Price Calculations

In order to evaluate alternative tax regimes, it is necessary to measure their impact on the cost of capital services. An increase in these costs would require an increase in the gross returns required by acceptable investment opportunities and, hence, a decrease in the amount of real investment undertaken. This, in turn, would mean a lower capital stock, a less productive labor force, and a lower GNP. We have measured the alternative costs of capital implied by various depreciation proposals via a "service price" calculation for each of 37 different asset categories covering 73 different industry classifications. This appendix describes those calculations.

The service prices calculated for each asset category represent the current marginal products required per dollar of corporate investment in that asset by each industry. They are the before-tax rates of return required to be produced by the asset in order that the anticipated taxes, depreciation, and a "normal" rate of return are covered. The normal real rate of return is assumed equal to 2.7 percent, a level we estimate to have prevailed during 1983. An asset category's rate of economic depreciation is assumed generally to vary across industries. Allowable tax lives also generally differ across industries, and allowable depreciation methods vary among the several alternative tax regimes in place in the U.S. during the period 1954 to 1983. These regimes include

(1) Bulletin F Guideline Lives
(2) Class Lives, using ADR write-off methods.
(3) Asset Depreciation Range (ADR), using that life within the given range that minimizes the service price (accounting for different investment tax credit rates according to the chosen depreciable life).
(4) Accelerated Cost Recovery System (ACRS) as originally passed in 1981 under ERTA
(5) ACRS as currently implemented.

The algebraic expression used for the calculation of the service price is derived from the first order condition for a wealth maximization problem. It assumes a constant investment deflator, measured relative to an overall price deflator, is expected to prevail over the relevant future. The maximization calculus is performed from the standpoint of the ultimate investor -- the individual stockholder. The existence of a corporate legal structure is deemed important only insofar as it creates an additional tax liability for the investor. The alternative, i.e., neglecting taxes on dividends, would be unsatisfactory; a corporation that (either explicitly or implicitly) neglects the additional taxes on dividends would fail to provide its stockholders with a market level, after-tax rate of return.

The service price expression for corporate capital is given as

Service Price = tp/(1-ts)

+ (1-k-D)/[(1-ts)*((1-tcf)*(1-td)*(1-tcs))*E]

where

tp = the rate of property taxation, assumed equal to 3.22% for current law examples.

ts = the rate of tax on output (e.g. a VAT or sales tax on all final product), assumed equal to 5.16%.

tcf = the federal corporate tax rate, assumed equal to 46% for current law examples.

tcs = the state corporate tax rate, assumed equal to 9.67%

td = the marginal dividend tax rate, adjusted to reflect the average timing difference between profit accruals and dividend receipts, assumed equal to 16.37% initially. This rate is assumed to be subject to bracket creep for future periods. See below.

k = the effective rate of the investment tax credit (the statutory credit, adjusted for the net income limitation), assumed equal to 9.23% for equipment and nonbuilding structures. This rate is adjusted downward for short lived assets under Class Lives, ADR, and ACRS.

D = the present value of the future stream of tax depreciation allowances, adjusted to an after-tax basis, i.e., the stream is multiplied by an appropriate tax factor. A nominal interest rate of 6.7% is used as the discount factor, reflecting a 4% rate of inflation assumed throughout. See below for a further description.

E = the present value of the "efficiency stream", i.e., the present value of the future real returns, measured as a percentage of the asset's initial marginal contribution to output. A real interest rate of 2.7% is used as the discount factor. See below for a further description.

The assumed average economic life for each asset/industry category is the applicable class life under the old ADR system. These lives were first introduced in 1962 under the Guidelines depreciation system. In some cases, the BEA asset categories that were used do not correspond exactly with the IRS class life categories. In those cases an average or representative life was chosen.

Variation in expected asset lives is simulated by the use of a truncated normal distribution centered on the assumed average economic life. This distribution is used to derive an asset "discard" function. The discard function assumes that some (small) proportion of an original investment in assets of a

certain type is discarded beginning at 50% of the assumed average economic life. It also assumes that some (equally small) proportion of the original investment is maintained up to 150% of the assumed average life. The other capital assets constituting the original investment bundle are discarded at ages in between 50% and 150%, with the greatest number being discarded at the average economic life. In addition, a concave efficiency function is assumed for all nondiscarded assets to reflect factors such as technological change. This function assumes that the loss of productive efficiency is smallest in the early years, and greatest in the final years for each particular asset. (This is the reverse of a geometrically declining efficiency schedule in which the greatest absolute efficiency losses are incurred immediately.) Combining the discard function with the concave efficiency function yields an overall efficiency function for a given investment bundle. The general shape of this function indicates an initial slow rate of efficiency loss for the investment, a faster rate as the original investment ages and assets are discarded, but again a slower rate as we reach the upper tail of the discard function. The overall function becomes zero at 150% of the average economic life. This methodology is identical to that used by the Office of Business Analysis, Department of Commerce in generating their capital stock database.

As stated above, the variable E represents the present value of the efficiency function just described. Alternatively, it can be viewed as a measure of the average life of a given asset category, with the measurement performed in units of current efficiency units. In the absence of taxation, E inverse by itself, would represent the "cost of capital". For example, with an infinitely lived asset (no efficiency loss and no discards), E would equal the present value of an infinite series of ones, or simply one over the discount rate. E inverse would therefore equal the real rate of interest. Similarly, under an assumption of geometrically declining efficiency, E inverse would equal the sum of the interest rate and the (constant) rate of depreciation. With the efficiency schedule described above, however, the present value formula cannot be so easily condensed, and the more general form of E inverse must be used to measure the joint requirement for interest and economic depreciation.

The tax depreciation write-offs used in deriving the term D are calculated according to the relevant taxation scheme. In all cases, a half-year convention is used. The appropriate tables found in the tax regulations are used for calculating personal property allowances under ACRS. A choice is allowed whereby either the original depreciable basis is adjusted downward by 50% of the investment tax credit or a 2% reduction in the allowable credit is taken. The allowance schedule for 18-year real property was constructed using the 175% declining balance method. Under the ADR and class life proposals, either a declining balance method (with a switch to straight line at the appropriate time) or sum-of-years'-digits method is chosen. For

Section 1245 property, either 200% declining balance or the sum-of-years'-digits method is used, depending on which yields the greatest present value of depreciation allowances. For Section 1250 property (which we equate with BEA's building categories), the method is limited to the 150% declining balance method.

The straight-line method of depreciation is used in calculating taxable dividends under all regimes. For ACRS, the lives specified in Code Section 312(k) are used. A five year write-off is used under the expensing alternative. Inflation indexing is not taken into account in this calculation.

The tax rate on dividends is assumed to increase slowly over time due to bracket creep. Both a real growth adjustment and an inflation adjustment in the marginal rate is incorporated. Possible anticipated future tax "cuts" intended to correct for bracket creep are not taken into account. The real growth factor used in the calculations is 2%; inflation is assumed to be 4%. Bracket creep elasticities of .3 are used, so that a 1.8% (.3(.02+.04)) annual increase in dividend tax rates is assumed. This translates into roughly a 30 basis point increase in the dividend tax rate per year. A dividend tax rate ceiling of 50% is imposed.

The nominal depreciation allowances are multiplied by the appropriate tax rates in order to express their impact in after-tax terms. The term D, mentioned above, is defined by the following expression, which accounts for the deductibility of state corporate taxes on the federal return:

D = Present value[

(tcf+tcs-tcs(tcf+td))*Corporate Allowance

+(td)*Straight Line Allowance]

This term D is akin to the investment tax credit as regards its impact on the cost of capital. The depreciation allowances reduce the cost of the initial investment in present value terms by a percentage equal to D. Notice that there is no necessary connection between D, which is based on the allowable tax life, and E, which is based on the assumed distribution of economic lives. Equating the tax life with an average economic life does not necessarily yield a more or less burdensome tax system. Also, the assumptions regarding the economic lives and the pattern of efficiency decay are seemingly irrelevant to the relative rankings of alternative depreciation rules on the service prices.

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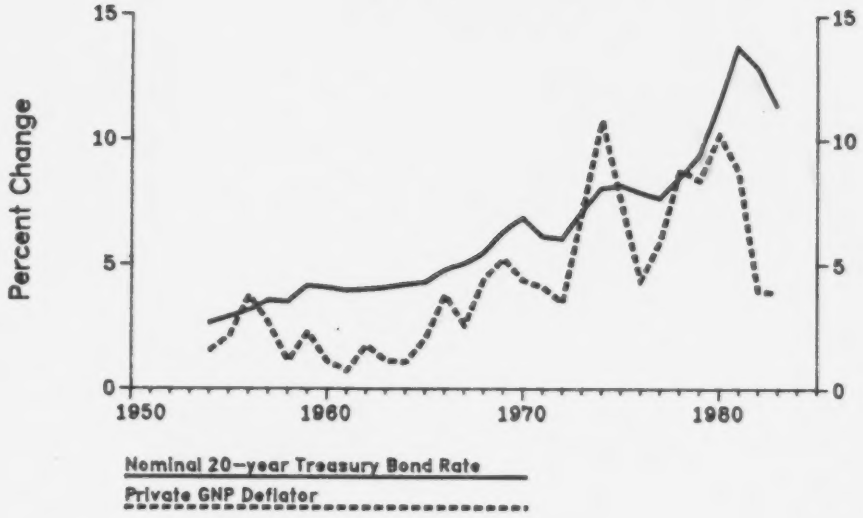
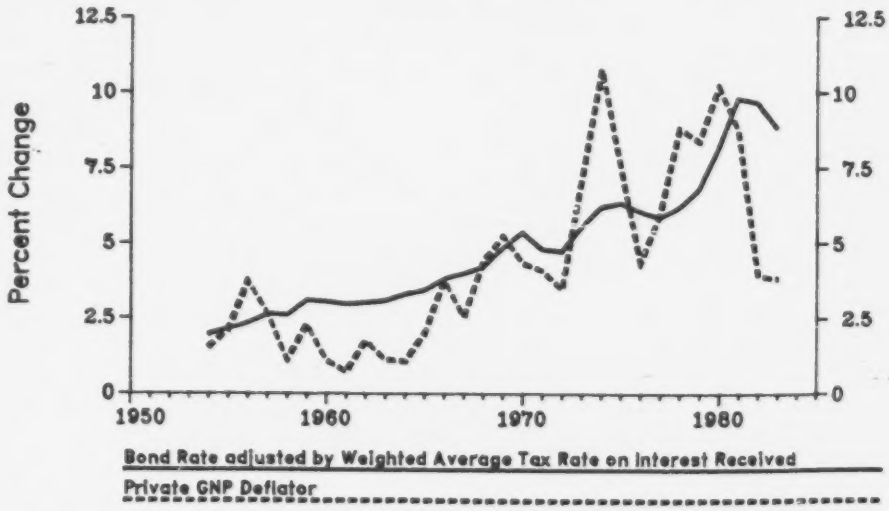
Plate 1

Nominal Interest Rates and Inflation (1954–1983)



Nominal After-Tax Interest Rates and Inflation (1954–1983)



Real After–Tax Returns to Capital and Financial Assets (1954–1983)

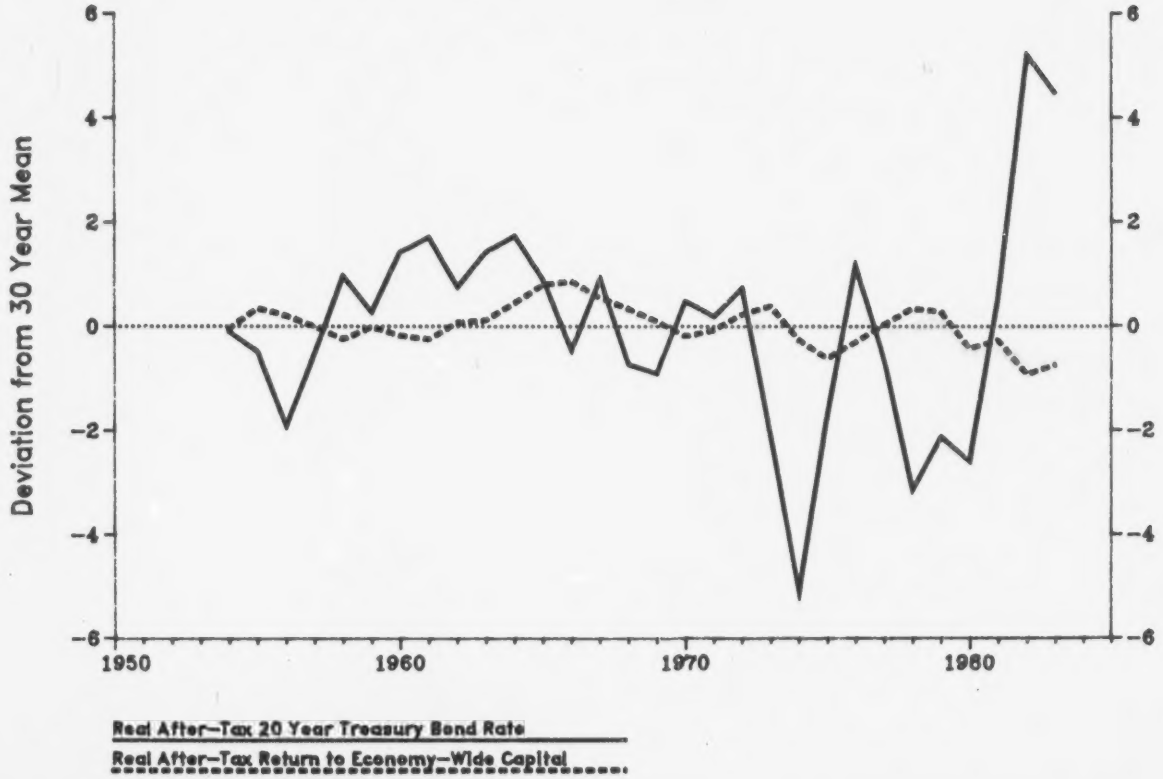
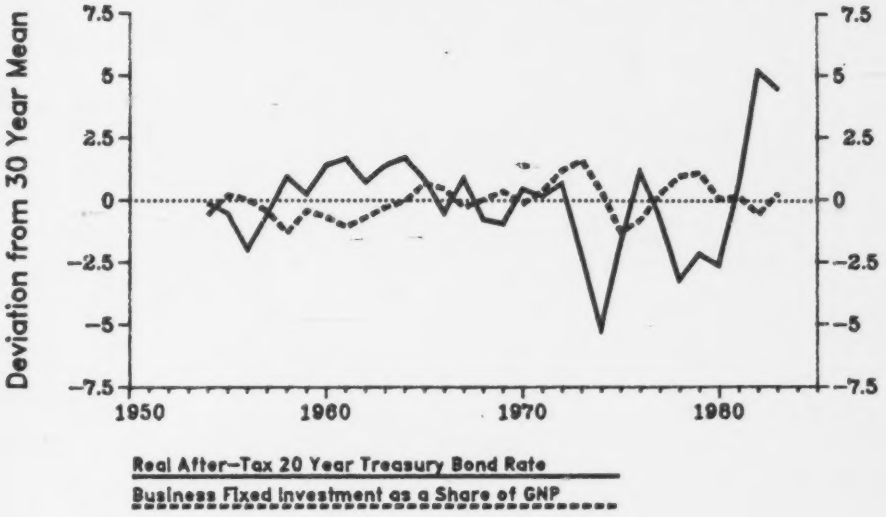


Plate 2

Plate 3

Real Financial After–Tax Return and Rate of Investment (1954–1983)



Real After–Tax Return to Capital and Rate of Investment (1954–1983)

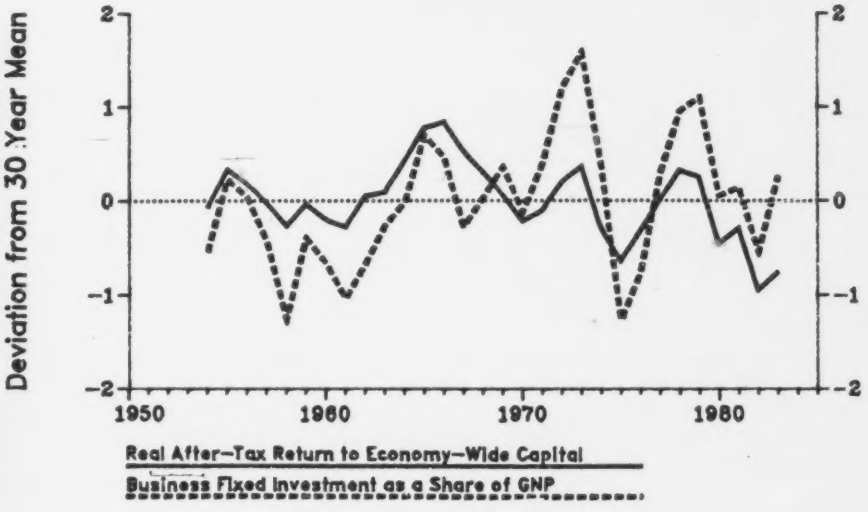


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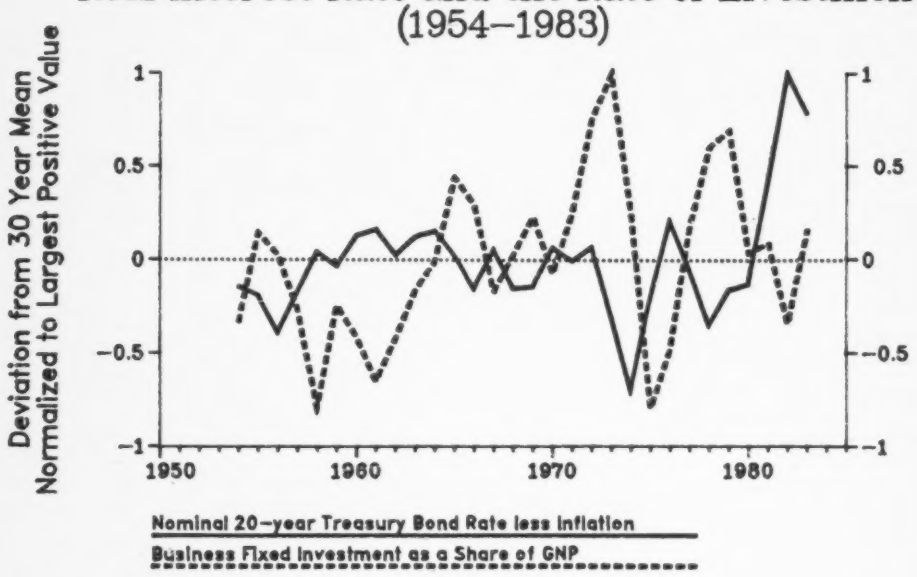
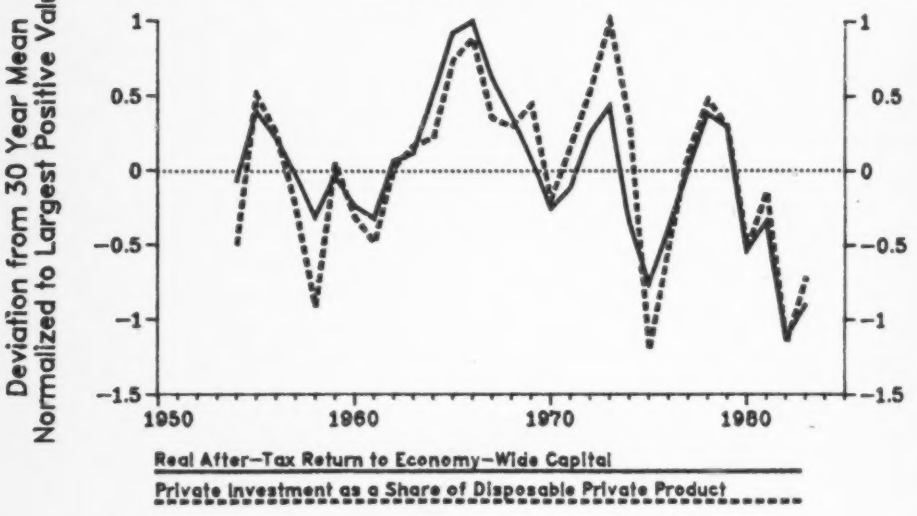
Plate 4

Real Interest Rate and the Rate of Investment (1954–1983)



Real After–Tax Return to Capital and Investment's Share (1954–1983)



Dr. ROBERTS. It's quite detailed and shows that the impact of taxation on the cost of capital is stronger than the impact of interest rates. And this, I think, is why the economy could grow so strongly and we could have such large increases in investment in 1983 and 1984 despite high real interest rates. So I think this basically bears on the main thrust of your concerns. If we get on a path in which we think that the key to economic success is interest rates and that the key to interest rates is deficits, we may not be right. And, therefore, we could not only fail to control spending, but we could make some other bad mistakes.

Senator WALLOP. It reminds me of those old boxes that they used to have from the Middle East that had about 11 keys to get into 1 drawer. And I think that's one of the things that maybe has us.

Senator PACKWOOD. One of the things, Malcolm, that I think causes this panel to agree, however, is that here we are talking only about spending cuts. For those who think if you narrow the deficits that will reduce interest rates, they can accept it, because it will reduce it.

In Dr. Roberts' case, I think he accepts it because he says it's good; it's a reduction in spending and reducing Government spending will help bring your interest rates down. So to that extent, the panel agrees, although perhaps for different reasons. That if we undertake the spending cuts of the magnitude the President is talking about, the interest rates will come down.

Senator WALLOP. I think I detected one or two "mays" in there.

Senator PACKWOOD. I don't think there were any mays. [Laughter.]

They may have different reasons for thinking that, but I didn't sense any of them having any doubts that they would come down.

Pat.

Senator MOYNIHAN. Mr. Chairman, I think we have kept our learned friends here a great length. Do you mind one bit of doggerel?

Senator PACKWOOD. Go right ahead.

Senator MOYNIHAN. If the question is very much too wide and much too deep and much too hollow, then learned men on either side use arguments I cannot follow. [Laughter.]

But could I just make one general statement after thanking them for their very clear exposition? I would hope that as we deal with the problem of the deficit we do not allow the deficit to become an instrument of a particular social policy. In other words, because of the deficit we have to do this or we have to do that, which is something which, in fact, individuals would like to do anyway but they find the deficits the best approach for requiring it to happen. I mean there are those who will say because of the deficit, let's get rid of the Marine Corps.

I think people that actually have in mind getting rid of the Marine Corps find the deficit a convenient excuse.

And I think, Mr. Chairman, in your great capacity, nobody understands better than you the effect of the tax system on social policy. That has been your argument on health care plans, on tuition tax credits, and on charitable contributions. You have seen the tax system as a statement of social policy as well as fiscal policy. And you are right.

And I would hope we could, as much as possible, insulate—let us not have, hidden agenda in which a real and actual social objective is pursued in the name of some fiscal formula.

Senator PACKWOOD. I know exactly what you mean. You and I have friends who would eliminate the military even if we had a budget surplus.

Senator MOYNIHAN. Yes, exactly. Precisely. And you and I are not of that ilk.

Senator PACKWOOD. That's correct. Max.

Senator BAUCUS. Just one question, Mr. Chairman.

I take it that all of you would agree that unspecified budget cuts are not going to have much of a positive effect on national markets. I say that because some of the administration's budget cuts in the outyears are specified but a good number of them are unspecified. And I take it that you talk about 2 or 3 percent reduction in interest rates—that assumes inactive specified cuts for those 3 years.

Dr. SCHULTZE. I don't know whether you remember, Senator, but asterisked cuts won't do it.

Senator BAUCUS. That's right. Thank you very much.

Senator PACKWOOD. Senator Danforth.

Senator DANFORTH. Gentlemen, there has been a general concensus that if we reduce spending this will have a beneficial effect on the economy and some of you have suggested that it would mean a reduction of interest rates of 2 percent, maybe 3, 4 percent. You have not dwelled at any length on what would happen if we do nothing. In other words, you have stated the up side of reducing spending, but not the down side of either doing nothing at all or of doing something which is very modest, maybe say $25 billion of budget cuts by 1988 or 1989. Are we courting disaster? Does the arsenic poisoning eventually kill the patient in Dr. Schultze's term? Is there any crisis or emergency that you could foresee that would be created by a do nothing policy on the part of the Congress?

Senator PACKWOOD. Alan, why don't you start? We have been starting with Marty all the time.

Dr. GREENSPAN. As I indicated earlier, Senator, the financial markets are really quite cynical and are presuming and, in fact, acting upon the presumption that nothing very much will happen. So if nothing happens, there may be some elements in the financial community which will get distressed and sell bonds and drive interest rates somewhat higher.

In the short run, I don't think that is likely to happen. Over the long run, however, the propelling force of the cumulative effect of interest payments changing the scenario in a manner which creates a real potential explosion of interest costs and, therefore, of deficits. At that point, you can then have a major rise in interest rates, perhaps of a very debilitating form.

However, the potential favorable outcomes of a serious and really credible addressing of this whole budget problem are marked. The potential rewards to the country are so great that I personally find it very difficult to believe that we will forgo those benefits merely because we can't find a simple formula of bringing down the deficit to, let's say, 10 percent of the level of expenditures. We are talking about trillion dollar budgets here, and we are

making an extraordinary issue of bringing down the rate of growth. Not cutting the absolute levels. And then we find that we are unable to do that. The markets assume that we are, indeed, unable to do that. I hope they are wrong. And if they are wrong, I think the benefits are just extraordinary.

Dr. ROBERTS. I think that regardless of the deficit, if the Government's budget continues to grow faster than the economy, then the markets and everybody in them will conclude that their property rights are less secure and this will affect investment rates and overall economic performance.

So I would predict that, if you fail to reduce the growth of Government spending, the economy's growth will slow down. And that this would be true regardless of whether there was or was not a deficit.

Dr. SCHULTZE. The first 11 pages of my testimony, which I didn't really get a chance to get into, went precisely to your question of what happens if we don't do anything serious about the deficit. And I won't summarize that except to say I do not believe it's a catastrophe. The catastrophe is there won't be a catastrophe. There will be just a slow grinding down of future growth and living standards. And that is terribly serious, even if not catastrophic. The patient won't die, but it will be enfeebled for a long time.

Second, I realize this is a little bit out of tune with this hearing, which is considering spending reductions, but I think there would be a serious risk in the Congress pinning all its hopes for deficit reduction, which is terribly important, on doing it all through the route of spending cuts, particularly when they virtually exclude defense and exclude Social Security.

So I would say there is no catastrophe facing you. There is a terribly serious problem. And, second, you can create, I think, some market problems if the Congress goes down a route that it is almost bound to stumble over and try to tell people that we can solve this problem without touching taxes, and without touching Social Security benefits. I just think that that is the road to trouble.

Senator DANFORTH. The road to what?

Dr. SCHULTZE. The road to trouble.

Dr. FELDSTEIN. I think that we as economists understand the slow grinding down process that results if we don't deal with the deficits. The erosion of savings, the inability to grow the capital stock, the adverse effects on investment, on research and development.

We don't understand crises until after they happen. They happen and then a few years later we figure out what we did that got us into that problem. The Europeans didn't expect that their unemployment rates would rise from 2 percent to 12 percent over a decade, and that somehow they wouldn't create jobs. It just wasn't predicted.

I don't know what crises could occur if we don't deal with the deficit. I do know that we have an economy that would be very different from the kind of very healthy economy that we can otherwise foresee. And that the long-term consequences of dealing with the deficit are reason enough for me to hope that you will act and will act quickly. But I would worry that there may be things that

moving into this totally unknown realm in which the Government borrows more than half of all of our savings year after year and real interest rates rise higher and higher would do damage of a sort that we cannot fully anticipate.

Senator PACKWOOD. Pat.

Senator MOYNIHAN. Thank you, Mr. Chairman, and gentlemen.

Senator PACKWOOD. Gentlemen, a most auspicious start. Thank you very, very much on relatively short notice for giving us this much time.

[Whereupon, at 4:25 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Statement

of

The Associated General Contractors of America

Presented to

The Finance Committee

United States Senate

On the Topic of

The Economic Impact of Spending Reductions

AGC is:

* More than 30,000 firms including 8,400 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;

* 111 Chapters nationwide;

* More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities and of the contract construction by American firms in more than 100 countries abroad.

The Associated General Contractors of America (AGC) represents more than 30,000 firms, including 8,400 of America's leading general contracting companies which are responsible for the employment of more than 3,400,000 individuals. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities. We are pleased to submit written testimony on the subject of the economic impact of spending reductions.

This statement is submitted in conjunction with Finance Committee hearings held on January 2, 1985 and we respectfully request that it be included in the printed record of the hearing.

We commend the Committee for addressing the need to achieve significant reductions in Federal spending.

The size of the federal budget deficits projected for the foreseeable future are indeed a cause for concern. Federal deficits will not disappear overnight, and both the legislative and executive branches will have to come to terms with the problem. The need for fiscal prudence is obvious.

But in the rush to address the federal budget's imbalance, the country cannot afford the federal policy equivalent of throwing the baby out with the bathwater. Some items in the budget are more significant in the long-term than they appear on the surface. An important case in point is infrastructure investment. The long range impact on the nation of not going forward with vital infrastructure projects would be disastrous. And this conclusion is not sensationalism, it has been validated by the results of numerous economic studies.

Infrastructure deterioration has been thoroughly documented in numerous studies during the past few years. AGC was at the forefront of such research with its study entitled, "America's Infrastructure: A Plan to Rebuild", which catalogued $3.03 trillion in needs that must be addressed over the next 19 years.

Many other studies have documented infrastructure needs.

America in Ruins, by economists Pat Choate and Susan Walker, published in 1981, was the first major comprehensive and statistically-supported review of the deteriorating conditions of America's basic public facilities. It documented the downward trends of public works investment over the past 20 years.

Hard Choices - A Summary Report of the National Infrastructure Study, produced by the Joint Economic Committee of the Congress, projected needs of $1.157 trillion through the year 2000.

Rebuilding America's Vital Public Facilities, published by the Labor-Management Group, a private, non-governmental group of labor and business leaders, determined that an annual investment of $38 billion for twelve years was needed for basic public works facilities.

Public Works Infrastructure - Policy Consideration for the 1980's, compiled by the Congressional Budget Office, estimates that a $36 to $53 billion increase in capital outlays by all levels of government between 1983 and 1990 is needed to remedy just seven infrastructure systems profiled in the study.

All of these studies agree that an inadequate national infrastructure system poses increasingly serious health, safety, and economic growth problems and that a significant shortfall in infrastructure funding exists.

The definitive case for rebuilding America's infrastructure rests on persuasive and overriding concerns for the public health and safety. While these issues are of paramount importance, the infrastructure's distinctive position as the base on which the nation's economic activity is built leaves no doubt that a continued shortfall of investment in public facilities will have extremely serious consequences for the nation's economy.

Although the costs of meeting infrastructure needs are substantial, the economic effects of not meeting those requirements are even more serious. While not all of the results can be predicted, in the last few years, where possible, the costs of allowing fragments of the infrastructure to continue to deteriorate have been quantified where possible. These efforts have produced the sobering information that an enormous portion of U.S. economic growth will be lost if steps are not taken immediately to rebuild the infrastructure.

For example, the Federal Highway Administration - Transportation Systems Center Study of Highways and the Economy concluded that allowing roads to deteriorate would cost $766 billion in lost gross national product (1983 dollars) through 1995. This loss amounts to one-fifth of the size of the economy in 1981, and twice all local and state government spending in 1981.

These negative effects, enormous as they are, are only part of the costs which would be inflicted on the economy. Every delay adds to the costs, and the sheer magnitude of the infrastructure investment needed will grow exponentially if action is not taken soon. When the long run consequences are taken into account, the seriousness of the infrastructure crisis may equal, if not outweigh, current deficit concerns.

While the nation's infrastructure requirements are clearly immense, recent studies have revealed that the economy will definitely benefit in a number of very important ways from infrastructure investment. The economic growth stimulated by the additional funding of unmet needs would translate into increased gross national product, higher employment and increased productivity with a negligible increase in inflation.

An October, 1984 study from Data Resources, Inc., an economic consulting firm headquartered in Lexington, Massachusetts, assessed the economic impact of an annual $10 billion, six-year increase in infrastructure investment.

Although the increase would represent only about 10 percent of the annual shortfall in investment in infrastructure, Data Resources, Inc. (DRI) found that substantial benefits would flow from the added investment. The major conclusions of the DRI study, America's Infrastructure: Effects of Construction Spending, Study of a $10 Billion Annual Infrastructure Investment, are:

- 0 The gross national product would increase by $141 billion as a result of the $60 billion (cumulative) investment.
- 0 The increased infrastructure investment would result in widespread employment gains, adding 1,927,900 jobs to the economy from 1984 to 1990.
- 0 Added investment in the nation's infrastructure would have an expansionary impact on not just construction but would spur production in a broad range of industries.

Judicious pruning of federal spending should be undertaken where the maximum savings can be achieved while sacrificing the least in terms of the country's future potential. Sacrificing infrastructure investment for short-term gains can only serve to saddle future generations with a low-growth economy and unfairly penalizes them for our fiscal imprudence. The infrastructure is the basis for all our nation's economic activity; allowing it to decay year after year is surely killing the goose that laid the golden egg.

In conclusion, AGC opposes any cuts in productive construction programs. Construction contributes to the nation's economic well-being, as demonstrated in the above-referenced economic studies. Instead of cutting or freezing construction programs, for which a clear need has been established, expenditures should be increased for construction funded by the federal government.

STATEMENT
on
THE ECONOMIC IMPACT OF SPENDING REDUCTIONS
for submission to the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Dr. Richard W. Rahn*
January 18, 1985

Summary

It took 160 years for federal spending to claim ten percent of our gross national product, which it did in 1940. Since that time federal spending has shot up to nearly 25 percent of our gross national product. At first, the acceleration of federal spending was actually lauded by many economists who failed to consider the serious disincentives associated with such a trend. Instead, they held that such spending, by adding to the overall demand for goods and services, would actually stimulate the economy. However, as tax rates rose to finance such expenditure, the returns to work, savings and investment had fallen. As a consequence, economic growth began to decline.

We have now come to realize that economic growth is dependent upon the reward to work, savings and investment. Robust economic growth cannot be sustained when such rewards crumble in the wake of rising government expenditures and taxation. Europe, for example, has pushed taxes and government expenditures as percentage of their GNP far beyond U.S. levels.

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*Vice President, Chief Economist, Chamber of Commerce of the United States

The result has been economic stagnation. Consequently, it is important for Congress to take the initiative in reducing federal spending. This will allow for lower rates of taxation and more resources for the private sector. The benefit will be a future of sustained economic growth.

The Classical Perspective on Government Expenditure

Our Founding Fathers passed on to successive generations a recipe for economic prosperity. They maintained that economic growth was dependent upon economic incentives. According to them, a high reward for work, creativity, savings and investment constituted the basis for a strong and vibrant economy. This was epitomized in James Madison's view of government and in his strong endorsement of free enterprise. His support for free enterprise was based on a belief that economic growth was maximized under a system of economic liberty--under a system where producers and workers had right the to reap the rewards of their labor. This sentiment is also illustrated by the fact that many common governmental powers of the day were not even proposed during the Constitutional Convention. The power to control prices, wages, interest rates, the quality of goods and the allocation of labor were not even considered by the Founding Fathers.

Economic growth was foremost in the minds of the Founding Fathers when it came to fiscal policy. The leading American statesmen supported the provision of a limited set of government services which were viewed as consistent with a policy of free enterprise and as essential for markets to function properly.

Thus, the level of government expenditures was to be narrowly circumscribed. In particular, the proper functions of government were limited to national defense, maintaining justice and public works. The Founding Fathers were hesitant to increase government spending further because more taxes would be needed, and this would reduce incentives for work, saving, and investment. For example, Ben Franklin maintained that higher taxes destroy individual industry, frugality and enterprise--all vital ingredients for economic growth. While Alexander Hamilton stated that "the most productive system of finance will always be the least burdensome." He further stated "Taxes must be confined within a narrow compass. The genius of the people will not tolerate the inquisitive and preemptory spirit of tax laws."

Unfortunately, the message of our Founding Fathers was nearly buried under an avalanche of economic advice based on a much different perspective. Under this alternative view or what many have called the "new" economics, economic prosperity was linked to the stimulation and management of aggregate expenditures. According to this "locomotive" theory of the economy, production is literally pulled or made dependent upon the expansion of aggregate spending. It was on this basis that many economists advocated increasing levels of federal spending. It was thought that such spending by increasing aggregate demand would boost the economy. Very little attention was paid to the incentive effects of such policies.

The demand management perspective set a disastrous course for fiscal policy in the post World War II era. As federal

expenditures accelerated over this period tax rates were continually boosted. However, the standard demand management analysis maintained that very little harm would come to the economy since the taxes raised by government would be merely spent by the government, leaving total spending in the economy the same. This ignorance of the supply side of the economy left unnoticed the mounting disincentives for production. For example, prior to 1969 the maximum tax rate on capital gains was 25 percent. By 1977, this rate had advanced to 49 percent, almost doubled. As a result, new capital raised through public stock offerings had tumbled from $1 billion in 1969 to $15 million in 1978.

In essence, federal tax policies during the 1970s were reducing our ability to produce goods and services while the Federal Reserve was pumping up the demand side of the economy through excessive monetary growth. As a consequence, prices soared as production fell. We found ourselves in the midst of "stagflation."

Times have changed. Double digit inflation, runaway federal spending, rising tax rates and the virtual collapse of economic growth during the 1970, have caused many to reject the "new" economics or the demand management approach to the economy. We have come to realize, along with Adam Smith and the Founding Fathers, that increasing expenditures is a rather simple process, given man's unlimited wants and the Federal Reserve System's ability to increase the money supply. In fact, the emphasis on expenditures can be easily abused by vote seeking politicians who have a vested interest in the propagation of runaway federal

spending. Instead, the economy's important challenge is production. However, production is dependent upon the supply of labor and capital which are dependent upon a high reward to work, savings and investment.

From this classical perspective, reducing the growth of our presently bloated federal budget would yield beneficial incentive effects. Reducing federal expenditures improves incentives by taking resources from the relatively inefficient public sector and putting them in the more efficient private sector. Study after study indicates that many federal programs are extravagant; could be more efficiently carried out by the private sector and lower levels of government; subsidize the wrong objectives; and are poorly administered. For example, the Grace Commission documents over $400 billion of such waste. Eliminating this waste is a sure way to expand the economic freedom of our citizens by giving them greater control over the economy's scarce resources, and improving our chances for economic growth.

The Deficit is a Symptom of a Larger Problem

While expenditure reduction has become an important topic, the budget deficit, to an even larger extent, has been singled out as a leading cause of our economic ills. For many, the deficit has taken on a character of its own -- breathing terror across the landscape. There is no doubt that the deficit is a problem of national concern. However, let us place it in its proper context. The root of our fiscal problems is not, as some try to make it, the deficit per se, but rather the level of government expenditure.

All too often this fixation over the deficit obliterates

the really critical issue: reducing excessive government. Many who seize upon the deficit issue make it appear that simply raising taxes will cure our fiscal problems. However, we should be painfully aware by now that increased taxation is associated with devastating disincentive effects of its own. Higher taxes discourage capital formation, increase the government's propensity to spend, and reduce the energies of the work force. The fact remains that the real cost of government is the level of government spending itself.

While the level of government expenditure should be the looming issue, many do not preceive this to be the case. Instead, the deficit debate focuses on the merits of higher taxation versus less "crowding out." This discussion makes it appear as if a mere substitution of one method of finance for another will result in gains to the economy. However, there is no escaping the fact that each method of finance extracts its price from the public. We must constantly remind ourselves that the deficit is a symptom of a larger problem: runaway expenditures. This is a problem that will not go away with higher taxes. You simply do not change the habits of an extravagant spender by providing him with more funds. Nonetheless, the notion that the deficit is an evil in and of itself now characterizes all public debate to the exclusion of everything else.

Over the past several years, the economics profession has carefully inspected this claim. These results are well summarized in the U.S. Treasury Department's study, Government Deficit Spending and Its Effects on Prices of Financial Assets. In this

comprehensive report, Treasury investigates the relationship between deficits and interest rates. Contrary to popular opinion, they find that this relationship is clouded with ambiguity. The report maintains that interest rates are determined by a number of other important factors such as the level of government expenditures, the disincentive effects of taxation, the time horizon and money supply policies. The report cites empirical work that suggests interest rates are correlated with the level of government expenditures, rather than the deficit per se. This supports the idea that the focus on deficits often blurs the most critical issue -- this being control over expenditure growth.

What does this research mean for public policy? It means that the scenario of the tax increasers is seriously in doubt. Their argument is that raising taxes will lower inflation. In fact, according to the Treasury report, the opposite is just as likely. This occurs because increased taxation carries along with it smaller disposable income, reduced incentives for work and savings, more underground activity, and less fiscal discipline. This adds up to less economic growth, a smaller tax base and few if any reductions of long run interest rates. Moreover, higher taxation, such as repeal of indexation, would increase the temptation for bracket creep and a return to inflationary monetary policy.

Let us not fall into the European "trap". Western Europe has tried to solve its deficit problems with round after round of tax increases. As a consequence, the European tax burden has increased from 31 percent of GNP in 1962 to over 46 percent in

1984. The results have been disastrous as real economic growth in Europe fell from an average of 4.8 per cent in the 1960's and early 1970's to 1.8 percent over the past ten years. What is even more startling is that such whopping tax increases have lead to a rising ,not a falling, deficit as government expenditures have risen to an astounding 51 percent of European GNP. The European experience should teach us here in the U.S.A. that what we need is federal spending cuts, not higher taxes.

The Impact of Expenditure Cuts

The primary economic impact of significant expenditure reduction will be to stimulate economic growth. It will literally pave the way for the implementation of a high growth policy. This will occur in a variety of ways.

First, reducing the growth of federal expenditures will help to eliminate the inefficient and extravagant programs found in the federal budget, in so doing, more resources will be shifted to the private sector, which will provide the basis for more economic growth and job creation. Painstaking research by reputable institutions such as the Congressional Budget Office, the Government Accounting Office, the Grace Commission, the Senate Finance Committee and the Heritage Foundation substantiates what is common knowledge -- that the federal government is severely bloated. These groups have located possible budget cuts that would amount to close to $200 billion in one year alone. This represents a vast pool of resources that could be reallocated to the private sector to stimulate economic growth.

Second, reducing the growth of government expenditure is

the only meaningful way to improve capital markets. Less government expenditure means less real "crowding out" in credit markets. In contrast, raising taxes to close the deficit will not provide any additional incentives for capital formation and may actually lead to net disincentives for capital formation. For example, simulations run by Data Resources Incorporated have shown that investment is more sensitive to changes in tax rates than interest rates. Consequently, higher taxes could lower the interest rate but the process would be an unfavorable one. The higher taxes would reduce the after-tax rate of return on investment and investment would decline. The drop in investment would lower interest rates, but that is not a desirable way to lower interest rates. The result would be lower interest rates and lower investment. Rising taxes also have the disadvantage of encouraging more not less, government spending. More taxes are a signal to special interest groups that more money is available for spending, thereby reducing fiscal discipline.

Finally, reducing the growth of government expenditures provides the opportunity for further cuts in marginal tax rates. The rapid economic growth we have recently experienced is a testament to the power of marginal tax reduction in unleashing incentive effects. The intent of the 1980 tax cuts was to provide incentives for investment and savings. In fact, gross private domestic investment during the recent recovery surged at seven times the growth in consumption and non residential fixed investment increased at a rate almost double the average for postwar recoveries. The gross private savings rate has risen

beyond its long-run average to a remarkable 19 percent of GNP in 1984.

Conclusion

The coming session of Congress could represent a landmark for economic policy. By focusing their efforts on a program for a significant reduction in government spending and steering clear of tax increases, the Congress can provide the basis for sustained economic growth. In this regard, the Chamber and other major business associations have endorsed a modified across-the-board federal spending freeze. Such a spending freeze can generate significant savings without causing undue hardship to any particular group. We hope the Congress will make use of such plans in order to bring about a significant reduction in federal spending.

Statement of
The Federation of American Hospitals

on the Economic Impact of Spending Reductions

Submitted for Inclusion in the Hearing Record
of January 2, 1985
of the Committee on Finance
of the United States Senate

The Federation of American Hospitals is willing to accept our fair share of responsibility in any attempt to reduce significantly the Federal deficit. However, the reported cuts for the Medicare program proposed by the Administration go far beyond any sense of fairness and proportion. The proposed reductions in Medicare are far greater than those suggested for any other federal program-- nearly $20 billion. Consequently, health care providers will be asked to absorb much more than their fair share of the reductions.

The Administration and Congress should note that the Medicare Hospital Insurance Trust Fund does not affect the Federal deficit. Payments to hospitals under Medicare do not come from general revenues; they are financed by a payroll tax. Therefore Medicare payments to hospitals do not contribute to the budget deficit and reductions in hospital payments will do nothing to decrease the interest on the federal debt. A severe reduction in payments however, will force hospitals to consider reductions in services.

The pending bankruptcy of Medicare can no longer be held out as a legitimate reason for drastic cuts in the program. The projected date for the insolvency of the Medicare Trust Fund is now beyond 1994--primarily because hospital costs increases are dramatically lower than projected levels.

During the period 1981 to 1983, the nation`s hospitals absorbed over 50 percent of all the Medicare cuts enacted by Congress. Last year's Deficit Reduction Act contained further substantial decreases in Medicare payments to hospitals. Simultaneously hospitals came under a tough new "prospective payment" system encouraging a new cost cutting competitive spirit in the health care marketplace.

Hospitals have responded to these cutbacks by saving the Medicare program literally billions of taxpayer dollars through the implementation of sound management procedures designed to provide high quality care at a reasonable price. Previously hospital costs were increasing at an unacceptable rate; in recent years that annual rate of increase reached 17%. However, this is no longer the case. Due to the more careful management of admissions, labor costs and utilization of facilities, the hospital industry has succeeded in bringing hospital costs down dramatically. In 1984, the annual rate of increase has been only about 4.3% or approximately the same as the general inflation rate.

Hospitals are not seeking special treatment. However, hospitals have done more than their fair share in reducing Medicare program expenditures over the last several years. We cannot continue to absorb Medicare payment reductions year after year, particularly those of the magnitude currently being proposed, without having to reduce the quality and quantity of services we provide.

We ask that Congress during its consideration of budget deficit reduction legislation, acknowledge the disproportionate savings to the Medicare program hospitals have already contributed as well as the greatly reduced rates of increase in hospital expenditures. The Medicare program and its providers and beneficiaries should not again be called upon to be the largest contributor to reducing the Federal deficit.

Electronic Industries Association

Peter F. McCloskey
President

January 10, 1985

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room #SD-219
United States Senate
Washington, D. C. 20510

re: Statement for the January 2, 1985, Hearing on the Economic Impact of Spending Reductions.

Dear Mr. DeArment:

One of government's fundamental responsibilities is to provide a stable and predictable economic climate. Whether a government intends to meet that responsibility can be measured by its willingness to follow sound fiscal and monetary policies and its unwillingness to compromise them for reasons of political expediency.

Government cannot habitually spend more than it collects without leading us into one of two eventualities: either inflation, which debases the currency and drains the savings of the citizens — or borrowing more and more of the capital which should be available for industry, thereby forcing interest rates higher and higher. While deficit drives up interest rates, it is also true that high interest rates are now adding billions to the federal deficit.

Starting now, the federal deficit must be narrowed. Industry appreciates that budgets cannot be rigidly balanced, that structural deficit can be the inevitable result of growth, and persist over a protracted period of time. But we know that deficits of the magnitude now confronting our nation for the foreseeable future cannot be assimilated. So, we are compelled to call for budgetary moderation by Congress and the Administration, for moderation through spending reduction far more than through tax increase, for reduction throughout the programs of all federal departments, including Defense.

Sincerely yours,

Peter F. McCloskey

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Testimony of

HARLEY M. DIRKS

President of

the

Health and Medicine Counsel of Washington
400 First Street, N.W., Suite 712
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Presented at Hearings Before

the

SENATE FINANCE COMMITTEE

Concerning

THE ECONOMIC IMPACT OF SPENDING REDUCTIONS

On

January 2, 1985

ECONOMIC IMPACT OF SPENDING CUTS THAT REDUCE THE FEDERAL DEFICIT

Harley M. Dirks, President
Health and Medicine Counsel of Washington
400 First Street, N.W., Suite 712
Washington, D.C. 20001

Mr. Chairman, there is no doubt that Congress will consider significant reductions in Federal spending. Under your leadership, we are pleased you are beginning at once to explore immediate, as well as long term economic, and human effects and benefits from spending reductions.

The President's budget will arrive on Capitol Hill shortly. Between now and then we have an opportunity to think about reality. The new majority leader, and former Chairman of this Committee, Robert Dole, says reality is reducing the federal deficit, and nearly all of us can agree. The reality is that after the election it has suddenly become a deficit of nearly two hundred and twenty billion dollars annually. Before the election, there was not much of a problem. It was only one hundred and seventy two billion dollars annually, and we were working our way out. Since the election, the recovery has become very fragile.

The Deficit

The pressure to reduce the deficit is real. For one reason, it may become even higher based on current policies. The President relishing his mandate said, "We will continue what we have been doing." This may no longer be adequate. As the

deficits soar, so does the interest that we pay on the deficit, taking precious dollars away from programs that help people. The Grace Commission won't save us either.

Tax Reform

As proposed, tax reform, will not reduce the deficit. Tax simplification is not the solution. According to press accounts, new Senate leadership, including the new Finance Committee Chairman, Robert Packwood, is understandably cool to the idea. The Democrats who have bailed out the President more than twice with unworkable economic plans are especially cool to the idea. Maybe the time has come for us to think about increased revenues, as well as reductions in Federal spending. Most Americans would be willing to shoulder an affordable increase providing they made a difference in the critical deficit issues --- and Federal funds went to appropriate programs and priorities. Statements about "over my dead body" is not a solution to the Nations tax problem.

Spending Freeze

Whenever this country gets into a deep fiscal crisis, the words "spending freeze" surface. There are constant advocates in the Administration and Congress. Some people believe that a spending freeze means that everyone would be frozen at the current level of spending. None of us should be that naive. Immediately upon the mention of freeze, exemptions are dicussed. The Social Security Trust Fund and its benefits head the list because of their political popularity. Defense spending is exempt, and then the list begins to grow and grow. Two categories emerge: ´social programs, and defense spending,

although the defense spending part of the budget does not include the CIA, foreign assistance, and the State Department and other programs. Social programs include everything but defense spending. No one can say education, health, and human development. Instead, we say social programs, because it gives a negative connotation of welfare. Then we start to think about the budget, and realize that the nearly uncontrollables, which become the untouchables, total approximately seventy percent of the budget. Then we talk about the touchables that are within the remaining thirty percent, and realize that the untouchables go up and the touchables go down. That's called a partial freeze. Example: the Defense Department is only talking about a thirteen percent increase for the coming fiscal year, an enormous amount of money. They say they may modify this increase. Maybe the time has come to put a cap on Cap Weinburger. A spending freeze is a cop-out, and not a solution to a difficult problem. Along with the spending freeze, the proposers are anxious to package the increases and decreases into one nice big package and push it through the Congress and have it signed by the President as quickly as possible --- long before members themselves understand it, and certainly before the taxpayers, voters, constituents and recipients understand it. Proposers are willing to subvert the Congressional process by by-passing the authorizing committees, the appropriation committees, and yes, even the budget process, and its timetable.

Congress

After the President's re-election he said, "It is the

beginning of everything. America's best days lie ahead." All of us take great hope in this statement and surely want to believe it. To several of us, his comment on continuing what we've been doing is what worries us most. Will we continue to cut back in farm food programs while many in the world are starving? Will there be more and more victims among the poor? Will there be more attempts to weaken environmental, consumer, health and safety laws, and more tax benefits to people with incomes over two hundred thousand dollars? Shortly we will see the President unveil his plan for, America's best days ahead, and it will be sent to the Congress. For some of us, those best days might lie with the actions taken by the Congress. As they go through the process of reorganizing themselves prior to beginning the 99th Congress, it is apparent that they are moderate. There will be a new leadership, and old leadership. Out of necessity, this Congress will bring about the artful game of compromise. Success for some of us who work for "social" causes will lie with the legislative giants, the experienced politicians and legislators, and the Committee Chairmen, especially this Committee. They give us our greatest hope that the system and the process will work as it has in the past, and that the burden of tax increases and reform, the deficit, and the freeze will not fall primarily on the backs of the poor, the elderly, and the sick. And the cuts will not come primarily on Medicaid, Medicare, Veteran's Health Benefits and Discretionary Health Programs, including Research and Prevention.

Mr. Chairman, being old, sick and poor is tough enough.

Why is it necessary to single out and punish Americans who fall into this category, by making them bear the burden of budget cuts created by failed economic policies -- which they have very little to do with? Why can't this nation talk about doing more to meet the needs of the poor, sick, and old people rather than less and less? Where is our courage when it comes to people?

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